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No. 06-

IN THE

Supreme Court of the United States

COLTEC INDUSTRIES INC.,

Petitioner,

v.

UNITED STATES,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

1. In determining that a transaction may be disregarded for tax purposes, should a federal court of appeals review the trial court's findings that the transaction had economic substance *de novo* (as three courts of appeals have held), or for clear error (as five courts of appeals have held)?

2. Where a taxpayer made a good-faith business judgment that the transaction served its economic interests, and would have executed the transaction regardless of tax benefits, did the court of appeals (in acknowledged conflict with the rule of other circuits) properly deny the favorable tax treatment afforded by the Internal Revenue Code to the transaction based solely on the court's "objective" conclusion that a narrow part of the transaction lacked economic benefits for the taxpayer?

PARTIES TO THE PROCEEDINGS

Pursuant to Supreme Court Rule 14.1, petitioner states that all parties to the proceedings in the court whose judgment is sought to be reviewed are listed in the caption.

RULE 29.6 STATEMENT

The parent corporation of Coltec Industries Inc is EnPro Industries, Inc. The real party in interest in this matter is Goodrich Pump & Engine Control Systems, Inc., whose parent corporation is Goodrich Corporation. Goodrich Corporation has no parent corporation and no publicly held company owns 10% or more of its common stock.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED FOR REVIEW	i
PARTIES TO THE PROCEEDINGS	ii
RULE 29.6 STATEMENT	ii
TABLE OF AUTHORITIES	v
JUDGMENT FOR WHICH REVIEW IS SOUGHT	1
JURISDICTION	1
STATUTES OR OTHER PROVISIONS INVOLVED	1
STATEMENT OF THE CASE	1
A. Statement Of Facts	4
B. Proceedings Below	9
REASONS FOR GRANTING THE PETITION	13
I. COURTS HAVE ADOPTED CONFLICTING STANDARDS OF REVIEW OF TRIAL COURT FINDINGS ON ECONOMIC SUBSTANCE	14
A. The Decision Below Deepens A Mature 5-3 Split In The Circuits Over The Proper Standard Of Review	14
B. The Decision Below Conflicts With Decisions Of This Court Requiring Deference To Trial Court Findings Of Fact On Economic Substance	16

TABLE OF CONTENTS – continued

Page

II. THERE IS A DEEP CONFLICT IN THE CIRCUITS ON THE SUBSTANTIVE STANDARD FOR DETERMINING WHEN A TRANSACTION MAY BE DISREGARDED UNDER THE TAX LAWS 18

III. THIS COURT'S REVIEW IS NECESSARY NOW TO RESTORE PREDICTABILITY TO THE ADMINISTRATION OF FEDERAL TAX LAWS 28

CONCLUSION 30

TABLE OF AUTHORITIES

CASES Page

ACM P'ship v. *Commissioner*, 157 F.3d 231 (3d Cir. 1998) 14, 21, 22, 28
ASA Investerings P'ship v. *Commissioner*, 201 F.3d 505 (D.C. Cir. 2000) 15
Aeroquip-Vickers, Inc. v. *Commissioner*, 347 F.3d 173 (5th Cir. 2003), *cert. denied*, 543 U.S. 809 (2004) 29
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American Elec. Power Co. v. *United States*, 326 F.3d 737 (6th Cir. 2003) 24
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Bail Bonds by Marvin Nelson, Inc. v. *Commissioner*, 820 F.2d 1543 (9th Cir. 1987) 22
Bazley v. *Commissioner*, 331 U.S. 737 (1947) 16, 17
Black & Decker Corp. v. *United States*, 436 F.3d 431 (4th Cir. 2006) 15, 19, 24
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Comdisco v. *United States*, 756 F.2d 569 (7th Cir. 1985) 14
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TABLE OF AUTHORITIES – continued

Page

Dow Chem. Co. v. *United States*, 435 F.3d 594 (6th Cir. 2006) 15, 21

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Helvering v. *Minnesota Tea Co.*, 296 U.S. 378 (1935) 23

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TABLE OF AUTHORITIES – continued

Page

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Nicole Rose Corp. v. *Commissioner*, 320 F.3d 282 (2d Cir. 2003) 14, 22
Ortiz v. *Fibreboard Corp.*, 527 U.S. 815 (1999) 4
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Rice's Toyota World, Inc. v. *Commissioner*, 752 F.2d 89 (4th Cir. 1985) 14, 19
Sacks v. *Commissioner*, 69 F.3d 982 (9th Cir. 1995) 15
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United Parcel Serv. of Am., Inc. v. *Commissioner*, 254 F.3d 1014 (11th Cir. 2001) 13, 20, 24, 28
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STATUTES

26 U.S.C. § 351 (1996) 1

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Page

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TABLE OF AUTHORITIES – continued

Page

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PETITION FOR A WRIT OF CERTIORARI

Petitioner Coltec Industries Inc ("Coltec") respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit.

JUDGMENT FOR WHICH REVIEW IS SOUGHT

The opinion of the Federal Circuit is published at 454 F.3d 1340 (Fed. Cir. 2006), and is reproduced in the Petition Appendix ("Pet. App.") at 1a-33a. Its order denying rehearing is unpublished and is reproduced at Pet. App. 124a. The opinion of the United States Court of Federal Claims is published at 62 Fed. Cl. 716 (2004), and is reproduced at Pet. App. 34a-123a.

JURISDICTION

The judgment of the Federal Circuit was entered on July 12, 2006. Pet. App. 1a. The Federal Circuit denied rehearing on September 19, 2006. Pet. App. 124a. This Court has jurisdiction pursuant to 28 U.S.C. § 1254.

STATUTES OR OTHER PROVISIONS INVOLVED

Relevant portions of the Internal Revenue Code, 26 U.S.C. §§ 351, 357, and 358 (1996), are reproduced at Pet. App. 125a-129a.

STATEMENT OF THE CASE

Faced with exploding asbestos injury claims against two of its subsidiaries, and the threat that asbestos plaintiffs would attempt to pierce the corporate veil to reach other corporate assets once insurance was exhausted, Coltec in 1996 engaged in a restructuring to isolate asbestos litigation management functions and asbestos liabilities in a single, well-capitalized

subsidiary. Coltec later sold shares in the new subsidiary to third-party banks, thereby recognizing for tax purposes the real economic losses already suffered by Coltec in the form of contingent asbestos liabilities. Coltec reflected this loss on its 1996 consolidated tax return. The IRS refused to allow the loss, assessed a deficiency, and denied Coltec's claim for a refund after Coltec paid the deficiency. Coltec then filed suit in the United States Court of Federal Claims. That court, after a 12-day bench trial with 29 witnesses, Pet. App. 62a, held that Coltec was entitled to the refund. On appeal, the Federal Circuit acknowledged that Coltec had complied with the statutory requirements for recognizing a tax loss, but invoked a crabbed version of the judicially created economic-substance doctrine to disregard that transaction for tax purposes.

The Federal Circuit engaged in impermissible judicial free-wheeling that nullified petitioner's statutory rights. Moreover, the decision below is rife with conflict with the decisions of other federal courts of appeals and of this Court. First, in the most fundamental of its holdings below, the Federal Circuit expressly disapproved the rule of the United States of Court of Appeals for the Fourth Circuit "that a transaction will be disregarded only if it both lacks economic substance and is motivated solely by tax avoidance." Pet. App. 24a n.14. The Federal Circuit held instead that "a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance." *Id.* at 24a. Indeed, the important question of the proper substantive standard under the economic-substance doctrine is the subject of a three-way split in the courts of appeals. Tellingly, the IRS Chief Counsel has acknowledged the three-way circuit conflict, and stated that "time will tell" what this Court ultimately rules. Donald L. Korb, *Korb Gives Speech on Economic Substance Doctrine* (Jan. 25, 2005), *available at* 2005 TNT 16-22 (LEXIS); *Korb Acknowledges*

U.S. Supreme Court May Need To Clarify Economic Substance Doctrine, Daily Tax Rep. (BNA) (Oct. 27, 2006).

Second, the Federal Circuit dispensed with the findings of the trial court that the transaction had economic substance by arrogating to itself the power to decide that question "without deference" to the trial court's findings. Pet. App. 28a. In so ruling, the Federal Circuit deepened a mature and striking (now 5-3) conflict in the courts of appeals over the standard of review. That ruling was critical to the outcome of this case because the judgment would not have been reversed if the Federal Circuit had paid proper deference to the findings of fact of the trial court.

Third, the Federal Circuit's analysis of the economic substance of the transaction has given rise to still more conflicts with precedents of this Court and other courts of appeals. The Federal Circuit reached its desired result by analyzing not the economic substance of the transaction as a whole, but the one slice of the transaction that resulted in tax benefits. Although its analysis of even that slice of the transaction is flawed, the Federal Circuit's surgical approach directly contravenes the established rule of other circuits, grounded in holdings of this Court, that the entire transaction must be considered. It also contravenes the longstanding rule set by this Court that taxpayers may structure real economic transactions to achieve tax savings. The Federal Circuit's rule that the IRS may isolate a tax-motivated element of a transaction, and require a showing of independent nontax economic benefits for each element, essentially eliminates taxpayers' ability to structure transactions using the type of tax planning that has been sanctioned by this Court.

Tax scholars and practitioners have long lamented the confusion and uncertainty that pervades the economic-substance doctrine. With the IRS aggressively invoking the doctrine, and with the governing judicial standards in disarray, taxpayers face unpredictability in structuring *bona fide* transactions

while taking tax considerations into account. This Court's intervention is imperative.

A. Statement Of Facts

The following summary of the facts is based upon the findings of fact after a bench trial by the Court of Federal Claims.

1. *The Asbestos Crisis.* "[A] tsunami of cases" alleging asbestos-related injury has swept over the nation's courts in the past three decades. Pet. App. 36a; *Ortiz* v. *Fibreboard Corp.*, 527 U.S. 815, 821 (1999) (discussing the crisis caused by the "elephantine mass" of asbestos-injury filings). Over 600,000 asbestos-injury claims had been filed nationally by the end of 2000. Stephen J. Crandall et al., RAND Inst. for Civil Justice, *Asbestos Litigation Costs and Compensation: An Interim Report* vi (2002) ("RAND Study"). Perhaps as many as 1 to 3 million claims will ultimately be filed. *Id.* at 77.

With many claims resulting in multimillion dollar judgments, "the financial viability of companies that manufactured or distributed products utilizing asbestos, as well as their insurance companies, was placed in jeopardy." Pet. App. 36a. The spiraling costs of litigation and liability began to exhaust insurance coverage, and 56 companies filed for bankruptcy between 1980 and 2002. *Id.* at 36a-38a. Moreover, even companies that never manufactured or distributed asbestos products became targets when plaintiffs "[s]eeking deeper pockets . . . began to assert corporate veil piercing claims designed to hold parent companies liable for the asbestos-related activities of their subsidiaries and/or successor companies." *Id.* at 38a. "By 1996, at least nine companies that were defendants in asbestos litigation faced such claims and, in seven of those cases, the federal and state courts involved ruled that the corporate veil could be pierced." *Id.* at 39a (citing cases).

2. *Coltec's Asbestos Risks.* The risk of corporate veil piercing was of paramount concern to Coltec, a publicly-

traded holding company that in 1996 consisted of 28 companies with net sales exceeding $1 billion and equity value of $1.5 to $2 billion. Pet. App. 40a. Coltec had asbestos risk through two subsidiaries: Garlock Inc ("Garlock") and The Anchor Packing Company ("Anchor"), a wholly owned subsidiary of Garlock.

Garlock, which Coltec acquired in 1976, had manufactured asbestos products. Pet. App. 40a. Aside from its direct liabilities, Garlock in 1987 had acquired Anchor, a distributor of asbestos-containing products. *Id.* In 1993, Anchor discontinued business operations, and "[b]y 1996, Anchor's only assets were nearly depleted insurance coverage and a small building in Louisiana." *Id.*

Asbestos claims continued to mount, and "[b]y the early 1990's, Anchor and Garlock were or had been defendants in approximately 100,000 asbestos cases." Pet. App 41a. A consulting firm in 1996 estimated the present value of Anchor's contingent asbestos liabilities *net of insurance recoveries* to range as high as $281.8 million, and Garlock's to be $88.5 million. C.A. J.A. 2751. The Government's own expert acknowledged that "the primary source of legal risk facing Coltec was the risk that the corporate veil would be pierced between Anchor [and] related companies, especially Garlock and Coltec." C.A. J.A. 3331.

3. *Coltec's Pre-1996 Risk Management Efforts.* John Guffey became the president and chief operating officer of Coltec in March, 1991 (and eventually the chief executive officer). Guffey, formerly the president of Garlock, was deeply familiar with the asbestos crisis, and he undertook to define a strategy for navigating that crisis. Pet. App. 41a. As the trial court found, "Guffey was very concerned that Garlock did not have a long-term strategy for management of asbestos litigation, including dealing with potential veil piercing claims, and he did not want these issues to distract management or cause problems with the daily operations of Garlock or other Coltec Group companies." *Id.* Thus, in 1992, Guffey created a spe-

cial Asbestos Litigation Department within Garlock to manage asbestos claims and insurance carrier relations "that was physically and otherwise isolated from other Coltec . . . operational and management functions." *Id.*

4. *Planning for the Transaction at Issue.* Joseph Andolino was a Coltec officer with responsibility for business development and tax, among other duties. Pet. App. 43a. "Andolino had frequent discussions with Coltec senior management about the uncertain and growing asbestos liability situation," *id.*, and Guffey had encouraged Andolino to address those risks.

In 1995, Andolino met with Arthur Andersen, Coltec's accounting firm and auditor, "to discuss overall tax planning," including dealing with an anticipated $240 million gain from the sale of a subsidiary. Pet. App. 43a. Andolino rejected various Andersen proposals, but at the end of the meeting an Andersen partner mentioned that he was aware Coltec had significant contingent asbestos liabilities and that he knew of a transaction involving the establishment of a litigation management corporation, funding of the liability, and a potential tax benefit. *Id.* at 43a-44a. Andolino was intrigued by the idea because such a restructuring would ameliorate Coltec's "'grave concerns about veil piercing'" and further Guffey's strategy "'to isolate the asbestos problem.'" *Id.* at 44a.

Although aware of the tax benefits of the transaction, Guffey – whose testimony the trial court specifically found to be "candid and credible," Pet. App. 80a – "'would have approved the restructuring in any event because of the benefits of protecting the assets of Coltec and Garlock from veil piercing claims.'" *Id.* at 31a. Furthermore, by isolating the asbestos liabilities and litigation management in a single subsidiary, "Guffey believed that the proposed transaction could further achieve operational objectives that he had been pursuing since he became President and CEO of the Coltec Group, as well as be helpful in recovering the costs of litigation management from Garlock's insurers." *Id.* at 45a. Timothy

O'Reilly, Coltec's chief asbestos litigation counsel, favored creation of the separate asbestos-litigation subsidiary "because it would help O'Reilly better identify and allocate costs so that additional insurance carriers might agree to contribute to the costs of managing Garlock and Anchor asbestos liabilities and potentially focus plaintiffs' attorneys on one pocket for recovery," and because, among other benefits, "placing the asbestos liabilities into a separate corporation could only help improve efforts to maintain Garlock's and Coltec's separate corporate identity to avoid 'veil piercing' claims." *Id.*

Coltec commenced planning the transaction in early 1996. As the trial court stated, noting a study that over 70% of veil-piercing decisions involved inadequately funded subsidiaries, "[i]t was very important for Coltec to establish a liability management company that was capitalized with sufficient assets to pay anticipated future net asbestos liabilities after insurance." Pet. App. 46a. To that end, Coltec engaged expert consulting firms to project future liabilities and potential insurance coverage. The final report contained low, medium, and high estimates, which the government's expert witness at trial conceded were reasonable. *Id.* at 47a-48a. The high estimate of net projected liability was $371.2 million (which, as noted above, included $88.5 million for Garlock, and $281.8 million for Garlock's subsidiary, Anchor).

5. *The Creation and Funding of the New Asbestos-litigation Subsidiary.* On June 6, 1996, Coltec decided to reconstitute an existing subsidiary that had discontinued business operations as a "'case management subsidiary,'" renaming it the Garrison Litigation Management Group, Ltd. ("Garrison"). Pet. App. 52a.

Coltec structured the transaction with the intent to isolate the Garlock and Anchor liabilities in Garrison while providing sound capitalization designed to enable Garrison to pay those liabilities, thereby minimizing the risk of veil-piercing. Coltec conservatively chose to fund the high estimate of $371.2 million of net asbestos liability. Pet. App. 50a. Gar-

lock created a long-term financial instrument to capitalize Garrison by having a viable subsidiary (Stemco Inc, which manufactured truck and auto parts) issue a 15-year promissory note to Garlock for $375 million plus interest at a floating rate. *Id.* at 52a-53a. Garlock then contributed to Garrison (i) the Stemco note, (ii) the stock of Anchor, (iii) the rights to all future asbestos insurance recoveries, (iv) the furniture, fixtures, and equipment used by the asbestos litigation department, and (v) all files and records relating to the asbestos litigation. Additionally, all 12 employees in Garlock's Asbestos Litigation Department were assigned to Garrison. *Id.* at 54a. In exchange for Garlock's contributions, Garrison (i) issued to Garlock 100,000 shares of Garrison common stock, (ii) assumed Garlock's asbestos liabilities, and (iii) agreed to manage, defend, and administer asbestos claims against Garlock. Since the goal was to strengthen rather than weaken the corporate veil around Anchor, Garrison did not assume Anchor's liabilities directly; it instead became Anchor's immediate parent corporation. Thus, after the transaction a plaintiff would have to pierce the veil of both Anchor and Garrison before reaching Garlock's and Coltec's assets. Garlock's basis in its Garrison shares after this transaction was just over $379 million, *id.*, which equaled Garlock's basis in the contributed assets, without reduction for the contingent asbestos liabilities transferred to Garrison. Coltec also transferred $14 million to Garrison in exchange for almost 100,000 shares of common stock and 1.3 million shares of preferred stock. *Id.* at 75a.

6. *The Third-party Stock Sale.* After Garrison was formed, Coltec began seeking third-party investors in Garrison. Pet. App. 55a-56a. Coltec had several motives in pursuing the sale. Consistent with the goal of isolating the asbestos problem, having third-party investors in Garrison would reinforce the distinction and separateness of the isolation vehicle. Selling Garrison stock to sophisticated investors would set the price and other terms of an arm's-length sale and would serve as a template for and facilitate subsequent sales of Garrison

stock. And it would allow Garlock to recognize for tax purposes the economic loss inherent in the business it contributed to Garrison. On December 20, 1996, Garlock sold its 100,000 shares of Garrison stock to two banks for $500,000. *Id.* at 98a-99a.

The banks did extensive due diligence on the proposed transaction, and the parties negotiated the terms vigorously. Pet. App. 56a. The Court of Federal Claims found that the sale was an arm's-length transaction. *Id.* at 107a.

7. *Tax Loss.* Garlock's transfer to Garrison of the Anchor shares, the assets associated with the business of managing the asbestos liabilities, and the Stemco note (which funded the asbestos liabilities) gave Garlock a basis of $379.2 million in the 100,000 Garrison shares it owned. Garlock's sale of those shares to the banks for $500,000 in an arm's-length transaction resulted in a capital loss of $378.7 million in 1996 that reflected the then present value of the future uninsured asbestos-related costs and expenses. Coltec used the loss to offset approximately $247.9 million in other capital gains in 1996, and carried forward the balance. Pet. App. 5a. The IRS audited Coltec's return, refused to recognize the loss, and assessed a deficiency. *Id.* at 6a-7a. Coltec paid the tax and claimed a refund, which the IRS denied.

B. Proceedings Below

1. *Court of Federal Claims.* Coltec timely filed suit for the refund in the Court of Federal Claims. That court held that Coltec was entitled to declare the loss and to receive a refund.

The IRS raised all manner of defenses, but the Court of Federal Claims roundly rejected them. The court held that the Garrison transaction satisfied the requirements for a tax-deferred transfer of property to a controlled corporation for stock under section 351 of the Internal Revenue Code, and Garrison's assumption of Garlock's contingent liabilities did not reduce Garlock's basis in Garrison's stock under section 358. Pet. App. 78a-91a.

The Court of Federal Claims also rejected the Government's attempt to rely on the statutory anti-abuse provision of section 357(b)(1), which provides that a liability assumption is considered money received, "for purposes of section 351 or 361" if the "principal purpose" for the assumption was to avoid income tax "on the exchange" or was not a *bona fide* business purpose. 26 U.S.C. § 357(b)(1) (1996). The court accepted the "candid and credible" testimony of Guffey that the tax benefit was not the "'principal reason'" behind the transaction; rather, it was to control better the asbestos litigation and exposure. Pet. App. 80a.

The court also found that "Guffey had every reason to be concerned about veil piercing claims against Garlock and Coltec in light of Anchor's diminishing insurance coverage," and credited testimony that Coltec needed security against "challenges from the plaintiff bar to pierce the corporate veil" or otherwise "get beyond Anchor into the Garlock assets and/or the Coltec assets." Pet. App. 82a.

The court further found that, based on Guffey's experience, "[t]he isolation of Garlock's contingent liability exposure from Coltec's core business also was an important factor in the company's ability to attract a suitor that might be willing to acquire the entire Coltec Group." Pet. App. 82a. The tax benefits of offsetting other capital gains "paled in comparison" to the business benefits of the transaction. *Id.* at 84a. Moreover, there was nothing artificial or transitory about the arrangement; "[t]he contingent asbestos liabilities assumed clearly were related to Anchor's, Garlock's, and Garrison's ordinary business, and the management and minimization of such liabilities were essential to the continued viability of Anchor and potentially Garlock." *Id.* at 90a. In this respect, the court noted that the events giving rise to the asbestos liabilities well antedated the transaction; Garlock, Stemco, and Garrison continue to function; and the separate Garrison transaction was an important factor in the later Goodrich acquisition of Coltec. *Id.* Thus, the court "determined that the

record in this case establishes that Garrison's assumption of Garlock's contingent asbestos liabilities had a '*bona fide*' business purpose." *Id.* at 91a. The court then held that the arm's-length sale of stock to the banks properly gave rise to a loss. *Id.* at 97a-114a.

Finally, the court rejected the Government's attempt to seek shelter under the judicially-crafted "economic substance" doctrine. The court stated that it "already ha[d] considered and held that Coltec satisfied the tax avoidance and business purpose tests in Section 357(b), therefore, *ipso facto*, the 'economic substance' doctrine is satisfied, since that doctrine requires proof of at least one of these tests." Pet. App. 115a. It further opined that, where "a taxpayer has satisfied all statutory requirements established by Congress, as Coltec did in this case, the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers." *Id.* at 119a.

2. *Federal Circuit.* On appeal, the Federal Circuit reversed. Like the trial court, the Federal Circuit held that the transaction complied with all statutory requirements. Pet. App. 17a. It held that the statutory business purpose test of section 357(b)(1) applied only to gain/loss determinations under sections 351 and 361, and not to basis calculations under section 358. *Id.* at 16a-17a. Nonetheless, after rejecting the trial court's constitutional concerns, it applied a narrow and contested version of the common-law economic-substance test and reversed the judgment.

The Federal Circuit began by declaring its formulation of the "general principles" of the economic-substance doctrine. First, "a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance." Pet. App. 24a. Second, the taxpayer bears '"an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to the kind of transaction that would never occur absent the motive of tax avoidance.'" *Id.* at 24a-25a. Third, "the economic

substance of a transaction must be viewed objectively rather than subjectively," and subjective purpose is simply a "pertinent" factor in making this objective determination. *Id.* at 25a. Fourth, "the transaction to be analyzed is the one that gave rise to the alleged tax benefit." *Id.* at 26a. Finally, "[t]he ultimate conclusion as to business purpose is a legal conclusion, which we review without deference." *Id.* at 28a.

In judging economic substance, the Federal Circuit treated the creation of the Garrison subsidiary as a series of distinct "transactions." The court acknowledged that the creation of a separate subsidiary to manage asbestos litigation may have had economic substance, but stated myopically that the only relevant "transaction" "is Garrison's assumption of Garlock's asbestos liabilities in exchange for the $375 million note," because "[i]t is this exchange that provided Garlock with the high basis in the Garrison stock." Pet. App. 29a.

Focusing on this narrow element of the transaction, the Federal Circuit rejected the claim that this exchange had economic reality. First, it did not accept that, as a result of the exchange, "'Garrison obtained the right to any "upside" if the future asbestos liabilities turned out to be less than the high estimate at the time of the contribution.'" Pet. App. 30a n.17. Despite its emphasis on economic substance as strictly an objective test, the Federal Circuit dismissed this consideration because "[t]here is no indication that this was viewed as a business purpose at the time of the transaction." *Id.* It regarded the half-million dollars that the banks later paid to own this upside opportunity as "nominal." *Id.*

Second, the Federal Circuit rejected Coltec's argument that the strengthened defense against veil-piercing claims gave the transaction economic substance, even though the trial court found such a purpose and credited CEO Guffey's testimony that he would have approved the transaction for that reason even in the absence of tax benefits. Pet. App. 31a. According to the Federal Circuit, economic substance is established "not by the subjective views of the taxpayer's corporate officers,"

and "objectively, there is no basis in reality for the idea that a corporation can avoid exposure for past acts by transferring liabilities to a subsidiary." *Id.* at 31a-32a. Therefore, the "assumption of Garlock's liabilities in exchange for the Stemco note . . . must be disregarded for tax purposes." *Id.* at 33a.

REASONS FOR GRANTING THE PETITION

Since *Gregory* v. *Helvering*, 293 U.S. 465 (1935), courts have disregarded "sham transactions without economic substance . . . for tax purposes." *United States* v. *Consumer Life Ins. Co.*, 430 U.S. 725, 736-37 (1977). In *Gregory*, this Court upheld the Government's determination that a stock transfer that the taxpayer claimed was a corporate reorganization was in reality a dividend, ruling that such "an elaborate and devious form of conveyance masquerading as a corporate reorganization" is a "transaction [that] upon its face lies outside the plain intent of the statute." 293 U.S. at 470. But

> [w]here . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

Frank Lyon Co. v. *United States*, 435 U.S. 561, 583-84 (1978).

Deep conflicts in the courts of appeals have emerged over the economic-substance doctrine[1] in the wake of *Frank Lyon*,

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[1] Courts have variously referred to the doctrine that emerged from *Gregory* as the economic-substance, *United Parcel Serv. of Am., Inc.* v. *Commissioner*, 254 F.3d 1014, 1018 (11th Cir. 2001), substance-over-form, *In re Comdisco, Inc.*, 434 F.3d 963, 965 (7th Cir. 2006), or sham-transaction doctrine, *Horn* v. *Commissioner*, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992). See Korb, *supra* (noting that the same doctrine goes by various names). Some courts refer to the sham-transaction doctrine as the

and the decision below presents those conflicts for resolution by this Court. First, there is a 5-3 split over the question of whether the standard of review is *de novo*. Second, there is a deep three-way split on the fundamental question of the proper standard for determining whether a court may disregard a transaction even though it complies with the statute. Finally, the Federal Circuit's analysis of the relevant transaction and its economic substance is contrary to the rulings of this Court and multiple courts of appeals.

I. COURTS HAVE ADOPTED CONFLICTING STANDARDS OF REVIEW OF TRIAL COURT FINDINGS ON ECONOMIC SUBSTANCE.

The Federal Circuit's ruling that the trial court's finding of economic substance was "a legal conclusion . . . we review without deference," Pet. App. 28a, draws that court into conflict with precedents of multiple courts of appeals and of this Court. This Court should resolve the conflict.

A. The Decision Below Deepens A Mature 5-3 Split In The Circuits Over The Proper Standard Of Review.

At least five circuits have correctly recognized that economic-substance determinations "raise predominately factual questions," and therefore clear error review is the proper standard. *Rexnord, Inc.* v. *United States*, 940 F.2d 1094, 1096 (7th Cir. 1991); *Comdisco* v. *United States*, 756 F.2d 569, 575 (7th Cir. 1985); *Nicole Rose Corp.* v. *Commissioner*, 320 F.3d 282, 284 (2d Cir. 2003); *ACM P'ship* v. *Commis-*

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overall test, consisting of a subjective inquiry into "business purpose," and an objective inquiry into "economic substance." *See, e.g., Winn-Dixie Stores, Inc.* v. *Commissioner*, 254 F.3d 1313, 1316 (11th Cir. 2001); *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985). The Federal Circuit, in keeping with its view that *Gregory* established a strictly objective test, refers to the entire doctrine as the "economic substance" doctrine, *see, e.g.*, Pet. App. 8a, 23a, and treats "business purpose" and "economic substance" as synonyms, *id.* at 28a-29a.

sioner, 157 F.3d 231, 245 (3d Cir. 1998); *Black & Decker Corp.* v. *United States*, 436 F.3d 431, 441 (4th Cir. 2006); *ASA Investerings P'ship* v. *Commissioner*, 201 F.3d 505, 511 (D.C. Cir. 2000). Such courts find that none of the traditional justifications for less deferential review applies to these fact-intensive determinations. See *Rexnord, Inc.*, 940 F.2d at 1097 (the appellate court is not "in a better position to weigh the relative significance of specific facts and assess the total character of the relationship . . . than the district court, who as the trier of fact heard the relevant testimony as well as reviewed the documentary evidence").

On the other side of the divide, the Federal Circuit has now joined a distinct minority of circuits that apply a *de novo* standard to determinations of economic substance. See Pet. App. 28a; *James* v. *Commissioner*, 899 F.2d 905, 909 & n.5 (10th Cir. 1990) (acknowledging circuit split); *Dow Chem. Co.* v. *United States*, 435 F.3d 594, 599 & n.8 (6th Cir. 2006) (applying *de novo* review to trial court's "ultimate conclusion" that the transaction was a sham).

Finally, at least four other circuits are internally divided, with panel decisions applying conflicting standards.[2] This Court should act to eliminate confusion on this important issue, which is squarely presented by the holding below and would be dispositive in this case.

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[2] *Compare, e.g.*, *Lukens* v. *Commissioner*, 945 F.2d 92, 97 (5th Cir. 1991), *with Compaq Computer Corp.* v. *Commissioner*, 277 F.3d 778, 780-81 (5th Cir. 2001); *Massengill* v. *Commissioner*, 876 F.2d 616, 619 (8th Cir. 1989), *with IES Indus., Inc.*, v. *United States*, 253 F.3d 350, 351 (8th Cir. 2001); *Thompson* v. *Commissioner*, 631 F.2d 642, 646 (9th Cir. 1980), *with Sacks* v. *Commissioner*, 69 F.3d 982, 986 (9th Cir. 1995) (acknowledging intra-circuit conflict); and *Karr* v. *Commissioner*, 924 F.2d 1018, 1023 (11th Cir. 1991), *with Kirchman* v. *Commissioner*, 862 F.2d 1486, 1490 (11th Cir. 1989).

B. The Decision Below Conflicts With Decisions Of This Court Requiring Deference To Trial Court Findings Of Fact On Economic Substance.

Not only does the decision below on standard of review deepen the conflict in the circuits, but it also runs afoul of precedents of this Court. In *Bazley* v. *Commissioner*, 331 U.S. 737 (1947), this Court reviewed the finding of the Tax Court that a recapitalization "had 'no legitimate corporate business purpose' and was therefore not a 'reorganization' within the statute." *Id.* at 739. This Court resolved "as a matter of law" the question of the scope of the statutory term "reorganization," holding that "[a] 'reorganization' which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders is not a reorganization under § 112." *Id.* at 743. But the Court also emphasized that "whether in a particular case a paper recapitalization is no more than an admissible attempt to avoid the consequences of an outright distribution of earnings turns on details of corporate affairs, judgment on which must be left to the Tax Court." *Id.* at 742. Finding "no misconception of law" that infected the Tax Court's application of law to facts, the Court's inquiry was at an end, "since the facts as found by the Tax Court br[ought] them within" the legal rule the Court established. *Id.* at 743.

Similarly, in *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945), the Tax Court had found that the declarations of a liquidating dividend were "mere formalities designed 'to make the transaction appear to be other than what it was', in order to avoid tax liability"; this Court held that those findings of fact of lack of economic substance were controlling, and the court of appeals was not permitted to draw different inferences from the record. *Id.* at 333-34.[3]

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[3] At one time, this Court regarded the Tax Court's findings of fact as conclusive; this Court later held that the same deference applied to fact findings of the Tax Court applied to any other trial court. *Commissioner* v. *Duberstein*, 363 U.S. 278, 291 n.13 (1960). The relevant point

This Court has always drawn distinctions between how transactions are characterized under the tax code (which may be reviewed *de novo*) and factual findings of economic substance (which are reviewed for clear error). In *Frank Lyon*, where the issue was whether a sale-and-leaseback transaction was a "sale" giving rise to deductions or a mortgage agreement and loan, this Court held that the "general characterization of a transaction for tax purposes" is a question of law subject to *de novo* review. 435 U.S. at 581 n.16. Here, however, the issue that the Federal Circuit decided *de novo* is not the legal characterization of a transaction under the tax code, but whether the Garrison transaction had any possible nontax economic benefits for Coltec. See Pet. App. 28a-33a. These are factual issues for which the trial court's findings warrant deference. *Bazley*, 331 U.S. at 742-43; *Frank Lyon*, 435 U.S. at 581 n.16 (citing *American Realty Trust* v. *United States*, 498 F.2d 1194, 1198 (4th Cir. 1974)), which holds that determinations of economic substance are factual issues for the jury).

This Court should resolve the sharp and mature conflict in the circuits over the standard of review, and vindicate its longstanding rule that such trial court findings are reviewed deferentially. This case presents an especially good vehicle to decide that question, since Coltec would have prevailed if the Federal Circuit had deferred to the well-supported findings of the Court of Claims on economic substance.[4]

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for this petition is that trial court determinations of economic substance are findings of fact, and thus only subject to clear error review.

[4] The Federal Circuit stated that "the underlying relevant facts are in large part undisputed." Pet. App. 28a. That statement is true insofar as the court is referring to the history and structure of the Garrison transaction and the stock sale to the banks. However, issues of whether the transaction appreciably affected Coltec's beneficial nontax interests, *id.* at 32a-33a, were of course hotly disputed facts between Coltec and the IRS. *Cf. Pullman-Standard* v. *Swint*, 456 U.S. 273, 287 (1982) ("'ultimate facts'" like "subsidiary facts" may be subject to deferential review).

II. THERE IS A DEEP CONFLICT IN THE CIRCUITS ON THE SUBSTANTIVE STANDARD FOR DETERMINING WHEN A TRANSACTION MAY BE DISREGARDED UNDER THE TAX LAWS.

The Federal Circuit's decision has also deepened a recognized split in the circuits over the proper substantive standard to apply in determining whether to disregard a transaction that otherwise qualifies for favorable tax treatment under the Code.

1. The Federal Circuit held that such a transaction should be disregarded if it "lacks economic substance," and "the economic substance of a transaction must be viewed objectively rather than subjectively." Pet. App. 23a, 25a. Subjective purpose is simply a "pertinent" factor in making this objective determination. *Id.* at 23a. The court further held:

> While the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance.

Id. at 24a (footnote omitted). In so ruling, the Federal Circuit acknowledged a conflict with the Fourth Circuit:

> We think that the rule adopted by the Fourth Circuit and reiterated in *Black & Decker* [*Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006)] – that a transaction will be disregarded only if it both lacks economic substance and is motivated solely by tax avoidance – is not consistent with the Supreme Court's pronouncements in cases such as *Frank Lyon*.

Id. at 24a n.14.

2. The conflict of authority is far deeper than the Federal Circuit acknowledged. Since this Court declared in *Frank Lyon* that the Government must honor "a genuine multi-party

transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached," 435 U.S. at 583-84, the courts of appeals have developed three divergent standards under the economic-substance doctrine. Specifically, the circuits have divided over whether this Court has mandated a "conjunctive," "disjunctive," or "unitary" test. Indeed, the IRS's chief counsel has acknowledged a three-way split of authority that invites this Court's intervention. *Supra* at 2-3.[5]

a. *Conjunctive Test.* The Fourth and D.C. Circuits have adopted a two-prong "conjunctive" test. The Fourth Circuit has held: "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, *and* that the transaction has no economic substance because no reasonable possibility of a profit exists." *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985). (emphasis added). In light of *Frank Lyon*, the Fourth Circuit concluded that "a transaction cannot be treated as a sham unless the transaction is shaped solely by tax avoidance considerations." *Id.* at 92; *Black & Decker*, 436 F.3d at 441.

The D.C. Circuit has adopted the same rule. That court noted that "[t]he Supreme Court's approach in [*Frank Lyon* and *Consumer Life*] demonstrates the separability of the 'business purpose' and the economic gain tests." *Horn* v. *Commissioner*, 968 F.2d 1229, 1238 (D.C. Cir. 1992). "[A]

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[5] The circuit conflict is extensively discussed in the scholarly literature. See, *e.g.*, Korb, *supra*; Zachary Nahaas, Note, *Codifying the Economic Substance Doctrine: A Proposal on the Doorstep of Usefulness*, 58 Admin. L. Rev. 247, 257 (2006); Yoram Keinan, *The Many Faces of the Economic Substance's Two-Prong Test: Time For Reconciliation?*, 1 NYU J.L. & Bus. 371, 407-16 (2005); Michael H. Paravano & Melinda L. Reynolds, *Tax Shelters: Evaluating Recent Developments*, 685 PLI/Tax 895, 913-18 (2005).

transaction undertaken for a nontax business purpose will not be considered an economic sham even if there was no objectively reasonable possibility that the transaction would produce profits." *Id.* at 1237 (emphasis omitted); *id.* at 1237-38 ("'The test inquires into the existence of a business purpose for the transaction and evaluates the economic substance of the transaction. The latter evaluation is to be guided by a more precise test of whether there is a reasonable possibility of a profit. Only if neither test were satisfied would the transaction be considered a sham transaction.'") (quoting Karen N. Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 Fla. L. Rev. 659, 670 (1989)).

b. *Disjunctive Test.* A second group of circuits (the Sixth, Eleventh, and Federal Circuits) have adopted a "disjunctive" test, holding that the absence of either objective economic substance or subjective business purpose is fatal to the transaction. In *Winn-Dixie Stores, Inc.* v. *Commissioner*, 254 F.3d 1313, 1316 (11th Cir. 2001), the Eleventh Circuit stated that the "sham-transaction doctrine . . . . provides that a transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, *or* if the transaction serves no business purpose." *Id.* (emphasis added). Additionally, "[o]nce a court determines a transaction [has no economic effects], no further inquiry into intent is necessary." *Kirchman* v. *Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989). On the flip side, "[e]ven if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance." *United Parcel Serv. of Am., Inc.* v. *Commissioner*, 254 F.3d 1014, 1018 (11th Cir. 2001) ("*UPS*").

Similarly, the Sixth Circuit has held that:

> "The proper standard in determining if a transaction is a sham is whether the transaction has any practicable economic effects other than the creation of income tax losses." If the transaction has economic substance, "the

> question becomes whether the taxpayer was motivated by profit to participate in the transaction." *"If, however, the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the [subjective] inquiry is never made."*

Dow Chem., 435 F.3d at 599 (citations omitted, alteration in original, emphasis added). The Federal Circuit follows the same disjunctive test, as noted above. Pet. App. 23a-24a. Thus, under the rule of the Sixth, Eleventh, and Federal Circuits, an objective determination of lack of economic benefits alone is enough to disallow a transaction for tax purposes.

c. *Unitary Test.* In yet a third camp sit the Third, Ninth, and Tenth Circuits. In *ACM Partnership* v. *Commissioner*, 157 F.3d 231 (3d Cir. 1998), the Third Circuit held that "[t]he inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them." *Id.* at 247 (quoting *Casebeer* v. *Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990)); *accord James*, 899 F.2d at 908-09 (viewing "business purpose and economic substance" as "factors to consider" in its sham transaction analysis). These courts expressly reject the Fourth Circuit's test. *Casebeer*, 909 F.2d at 1363 (finding the Fourth Circuit test "has no merit" because "the Court's holding in *Frank Lyon* was not intended to outline a rigid two-step analysis"); *James*, 899 F.2d at 908-09 (finding the Ninth Circuit to have a "better approach" than the Fourth Circuit). The Third Circuit explained its divergence from the Fourth Circuit framework as follows: "[The] distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes." *ACM*, 157 F.3d at 247 (quoting *Casebeer*, 909 F.2d at 1363).

These courts, like the "conjunctive" test circuits, depart from the second group of "disjunctive test" circuits because a finding of lack of objective economic substance does not end the inquiry. Compare, *e.g.*, Pet. App. 23a-24a, and *Kirchman*, 862 F.2d at 1492, with *ACM*, 157 F.3d at 251-57 (holding that the transaction lacked objective economic substance, and then proceeding to analyze the taxpayer's subjective business purposes). To support this approach, these courts reason: "From the time of *Gregory*'s analysis of the 'rational business purpose,' courts have evaluated taxpayers' purposes when determining whether a transaction has economic substance." *In re CM Holdings, Inc.*, 301 F.3d 96, 106 (3d Cir. 2002).[6]

As the last quotation indicates, this Court's intervention is imperative not only to bring uniformity to administration of the federal tax laws, but also because the Federal Circuit's ruling is directly contrary to this Court's precedents. *Gregory* emphasized subjective purpose in disallowing a corporate reorganization that lacked "business or corporate purpose," but was instead "a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character," with "the sole object . . . to transfer a parcel of corpo-

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[6] As for other circuits, decisions in the Second Circuit are conflicting. *See Nicole Rose*, 320 F.3d at 284; *Gardner* v. *Commissioner*, 954 F.2d 836, 839 (2d Cir. 1992) (per curiam); *Gilman* v. *Commissioner*, 933 F.2d 143, 147 (2d Cir. 1991). The positions of the First and Seventh Circuits are ambiguous. *Dewees* v. *Commissioner*, 870 F.2d 21 (1st Cir. 1989); *Yosha* v. *Commissioner*, 861 F.2d 494 (7th Cir. 1988). The Fifth and Eighth Circuits have noted the intercircuit conflicts but declined to take a definitive position. *Compaq Computer*, 277 F.3d at 781-82; *IES Indus.*, 253 F.3d at 353-54. Adding to the confusion, there are competing formulations of what is necessary to show objective economic substance, *see, e.g.*, *ACM*, 157 F.3d at 235 n.6; *Bail Bonds by Marvin Nelson, Inc.* v. *Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987), and whether subjective business purpose must be a principal or only a partial purpose, *compare, e.g.*, *Zmuda* v. *Commissioner*, 731 F.2d 1417, 1421 (9th Cir. 1984), *and Friedman* v. *Commissioner*, 869 F.2d 785, 792 (4th Cir. 1989), *with Peat Oil & Gas Assocs.* v. *Commissioner*, 100 T.C. 271 (1993), *aff'd sub nom. Ferguson* v. *Commissioner*, 29 F.3d 98 (2d Cir. 1994).

rate shares to the petitioner." 293 U.S. at 469. Similarly, this Court has distinguished between "a sham" that is "a mere device *intended* to obscure the character of the transaction" and "a bona fide business move." *Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378, 385 (1935) (emphasis added); *Frank Lyon*, 451 U.S. at 583-84 (sham transaction is one "shaped solely by tax-avoidance features"). The Federal Circuit used the language of *Gregory* but, in conflict with other circuits, improperly redefined "business purpose" as strictly an objective concept equivalent to economic substance. See *supra* n.1. It did so even though Congress in section 357(b)(1) had specified a narrower, subjective "business purpose" test for property transfers with controlled corporations, and declined to make that test applicable to basis calculation under section 358. 26 U.S.C. §§ 357(b)(1), 358 (1996); Pet. App. 16a-17a.

This case is an excellent vehicle for resolving the three-way circuit conflict on the substantive standard because Coltec would have prevailed in the Fourth and D.C. Circuits, where unquestionably a transaction is not a sham so long as it has at least a subjective business purpose, and quite possibly in circuits applying the unitary test, where the taxpayer's subjective business purpose would be taken into account. The Federal Circuit did not question the trial court's findings that Coltec executives were motivated by a desire to protect against veil piercing and would have executed the Garrison transaction regardless of tax benefits. Rather, it held that "[t]hese subjective views of Coltec's executives, even if credited, as they were by the Court of Federal Claims, are insufficient to establish economic substance," because "economic substance is measured from an objective, reasonable viewpoint, not by the subjective views of the taxpayer's corporate officers." Pet. App. 31a.

3. The Federal Circuit's analysis of the transaction for economic substance highlights even more confusion among the lower courts. This Court long ago established the rule that, in determining economic substance, "*the transaction must be*

viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant," *Court Holding Co.*, 324 U.S. at 334 (emphasis added),[7] and that rule continues to prevail in most circuits.[8] Thus, the Fourth Circuit – in a case like this one involving both an assumption of contingent liabilities by a corporate affiliate and a third-party sale – characterized the transaction as consisting of those two phases, and remanded the case to the district court to resolve the IRS's claim that the "two-phase transaction" lacked economic substance. *Black & Decker*, 436 F.3d at 433, 442.

The Federal Circuit, by contrast, did not analyze the two-phase transaction, or even the more limited transaction recapitalizing Garrison through the transfer by two corporations of numerous assets in exchange for stock and the assumption of liabilities. Instead, it took that transaction and carved out a transfer by Garlock of solely the Stemco note in exchange for solely the assumption of liabilities. In the apt phrase of one commentator, the Federal Circuit took "a scalpel to carve out an isolated part of a transaction," Sheryl Stratton, *Korb, Practitioners Discuss Economic Substance Cases* (Oct. 27, 2006), *available at* 2006 TNT 208-2 (LEXIS), demanding a showing

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[7] *See Gregory*, 293 U.S. at 470 (analyzing "the whole undertaking"); *Frank Lyon*, 435 U.S. at 581-83 (analyzing totality of transaction and identifying 26 factors relevant to the sham inquiry).

[8] *Hutton* v. *United States*, 501 F.2d 1055, 1061 (6th Cir. 1974) (stating "the district court properly looked to the entire transaction in assessing the economic realities"); *American Elec. Power Co.* v. *United States*, 326 F.3d 737, 742 (6th Cir. 2003) (rejecting the taxpayer's argument to segregate the transaction into separate, economically meaningful transactions and requiring the "plan as a whole" to have economic substance); *Kirchman*, 862 F.2d at 1493-94 ("Petitioners are correct in asserting that the tax court was obligated to analyze the entire transaction."); *UPS*, 254 F.3d at 1019-20 (resisting the government's attempt to segregate, from UPS's express mail business, parcel insurance arrangements under which it paid deductible premiums directly to an offshore affiliate, because the arrangements "figure[d] in a bona fide, profit-seeking business" and "simply altered the form of an existing, bona fide business").

of objective economic substance specifically for the exchange of the Stemco note in return for the transfer of asbestos liabilities that the note funded. Pet. App. 28a-30a.

This Court has declared that "the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Gregory*, 293 U.S. at 469. Similarly, in *Frank Lyon*, this Court said that "[t]he fact that favorable tax consequences were taken into account by [the taxpayer] on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction." 435 U.S. at 580. The rule of the Federal Circuit – that the court may identify a single, tax-motivated component of an integrated transaction as the relevant one for applying the economic-substance doctrine – cannot be reconciled with the longstanding legal right recognized by this Court. Only the Third Circuit has parsed a transaction almost as finely as the Federal Circuit, drawing fire from leading tax commentators for a "surgical approach" that isolates the "tax-motivated transaction steps" of an integrated transaction, thus dictating the outcome under the economic-substance doctrine. David P. Hariton, *The* Compaq *Case, Notice 98-5, And Tax Shelters: The Theory Is All Wrong*, 94 Tax Notes 501, ¶ 26 (Jan. 28, 2002) (discussing *ACM*, *supra*). The Federal Circuit's arbitrary definition of the transaction in this case illustrates the perils of the standardless common-law power that some federal courts are now wielding to deny taxpayers benefits that Congress has conferred in the tax code. If courts are permitted to dissect a transaction so finely and examine only the tax-motivated component, it will eradicate taxpayers' legal right to minimize tax liability.

Moreover, the Federal Circuit's analysis of economic substance, even as to the narrow slice of the transaction that it identified as relevant, is highly flawed. Although full exposition of economic substance awaits the merits briefs, the Fed-

eral Circuit disregarded the exchange of the Stemco note for the transfer of liabilities because purportedly the exchange had "absolutely no [e]ffect on third party asbestos claimants." Pet. App. 32a. While such plaintiffs could continue to sue Garlock, and while the restructuring did not effect release of any claims against Garlock for the asbestos injuries it caused, the Federal Circuit overlooked the effect of the transaction on the risks posed to Coltec and Garlock of *Anchor's* liabilities, which constituted 76 percent of the high estimate of Coltec's net asbestos exposure. *Id.* at 31a-32a. Garlock had acquired Anchor in 1987, long after most, if not all, of Anchor's asbestos sales were made.[9] The risk to Garlock and Coltec after recapitalizing Garrison would arise, in time, only if there were grounds to pierce both the Anchor and Garrison corporate veils.

Despite the claim to clairvoyance in the opinion below about how courts would treat future veil-piercing claims against Coltec, "the current state of veil-piercing law is chaotic," Stephen B. Presser, *The Bogalusa Explosion, "Single Business Enterprise," "Alter Ego," and Other Errors*, 100 Nw. U. L. Rev. 405, 411 (2006), and "[t]here simply are no bright-line rules for deciding when courts will pierce the corporate veil," Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. Corp. L. 479, 513 (2001). In the face of this uncertainty, Coltec had legitimate and objective business reasons to engage in a corporate restructuring to strengthen its defenses against veil piercing. The restructuring ended the relatively brief Garlock-Anchor ownership connection, which would be the predicate for piercing of Garlock's veil. Coltec would continue to be the majority owner of Garrison, but Coltec's

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[9] Asbestos had largely disappeared from commercial use by the 1970s. *In re Joint E. & S. Dist. Asbestos Litig.*, 129 B.R. 710, 737 (E.D.N.Y. 1991), *vacated on other grounds*, 982 F.2d 721 (2d Cir. 1992). But asbestos-related disease often has a latency period as long as 40 years, so new claims arise long after the exposure occurred. *Amchem Prods., Inc.* v. *Windsor*, 521 U.S. 591, 598 (1997).

corporate veil would be strengthened in multiple ways. First, Garrison – which received shares in Anchor, and did not assume Anchor's liabilities, only Garlock's – would be the direct parent of Anchor, whose veil would have to be pierced before Garrison's veil could be pierced to get to Coltec. Second, the new structure, in which Garrison would be a distinct but not wholly owned subsidiary of Coltec, underscored the separateness of the two corporations. Indeed, it is ironic that the Federal Circuit claimed that isolating asbestos liability in a separate corporation was solely a tax contrivance, and then in the next breath acknowledged that the banks that purchased the Garrison shares set up separate subsidiaries to protect against veil-piercing claims, even though they had no tax reason to do so. Pet. App. 32a. Third, veil piercing is an exercise of a court's equitable powers based on the specific facts of the case, *FMC Finance Corp.* v. *Murphree*, 632 F.2d 413, 422 (5th Cir. 1980), and one of the principal factors that commonly leads to veil piercing is undercapitalization of the subsidiary, *Eagle Transport Ltd.* v. *O'Connor*, 470 F. Supp. 731, 733 (S.D.N.Y. 1979); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89, 113 (1985). The full and conservative funding of Garrison's projected net asbestos liabilities by the $375 million Stemco note insulated Coltec from charges of undercapitalization, thus minimizing the chances of veil piercing.

Given that many once-healthy companies have been brought down by asbestos liabilities, Coltec had substantial reason to reorganize to protect corporate assets from veil-piercing claims, and gain thereby (as the trial court found) also the derivative benefit of enhancing its "ability to attract a suitor that might be willing to acquire the entire Coltec Group." Pet. App. 82a. Indeed, the isolation of asbestos liabilities in a well-capitalized Garrison was a major factor that enabled the sale of Coltec to The B.F. Goodrich Company (now Goodrich Corporation) in 1999. *Id.* at 59a, 83a-84a. "[A] transaction has a 'business purpose' . . . as long as it fig-

ures in a *bona fide*, profit-seeking business." *UPS*, 254 F.3d at 1019. Despite the Federal Circuit's claim that "objectively, there is no basis in reality" to this corporate restructuring, Pet. App. 31a-32a, strengthening corporate veils by any legal means is an economically substantial and common tactic for corporations faced with potentially devastating liabilities.

The economic-substance doctrine is not a source of common-law power for a court to substitute its judicial sense of the economic benefits of corporate transactions for the good-faith business judgment of experienced corporate officers and lawyers deeply conversant with asbestos liability, thereby depriving a taxpayer of benefits to which it is entitled by the plain terms of the Internal Revenue Code. Sham transactions generally involve transitory arrangements with no connection to the taxpayer's historic business and artificial losses with no economic corollary, *UPS*, 254 F.3d. at 1019-20; the economic-substance doctrine cannot be used against a taxpayer where (as here) the transaction "precipitated the realization of actual economic losses arising from a longterm, economically significant investment." *ACM*, 157 F.3d at 251 (citing *Cottage Sav. Ass'n* v. *Commissioner*, 499 U.S. 554 (1991)); Joseph Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 17-18 (2000) (defending *Cottage Savings* exception to economic-substance doctrine for transactions "tied to ordinary business operations").

III. THIS COURT'S REVIEW IS NECESSARY NOW TO RESTORE PREDICTABILITY TO THE ADMINISTRATION OF FEDERAL TAX LAWS.

As the conflicts discussed above betray, "[n]otwithstanding the doctrine's longevity, . . . the exact contours of the business purpose requirement, and even its proper formulation, remain unclear." 2 Martin D. Ginsburg & Jack S. Levin, *Mergers, Acquisitions, & Buyouts* ¶ 609, at 6-194 (2003). "[T]he courts have struggled with defining the concepts of 'economic substance,'" Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates & Gifts* ¶ 4.3.4A at S4-

19 (Supp. No. 2, 2006), and the result is a doctrine that is "open [to] multiple interpretations." Bankman, *supra*, at 29.

This Court's review now is vital because of the IRS's increasing aggressiveness in asserting that transactions lack economic substance whenever a taxpayer attempts to structure a high-dollar transaction to secure favorable tax consequences. See Eileen J. O'Connor, *Enforcement Is Progressing, Justice Department Attorney Testifies At Senate Finance Hearing*, 114 Tax Notes 42 (June 14, 2006). As a result, a growing number of tax cases are being decided in the courts on the basis of the economic-substance doctrine, with 13 decisions in the courts of appeals since 2000.[10] This number understates the accelerating pace of controversy, since many taxpayers have accepted settlements rather than litigate. *Id.*; B. John Williams, Jr., *IRS Chief Counsel Offers Tax Shelter Resolution Strategies*, 40 Tax Notes 20 (Feb. 25, 2003).

With conflicting standards and frequent appellate reversals, commentators deplore the lack of "predictability in tax planning and fairness in outcome" arising from recent cases such as the one here.[11] Critics rightly attack the Federal Circuit's decision as an example of how courts "applying broad equitable principles can lead to unintended consequences and inject

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[10] See, in addition to the cases cited already *supra*, *TIFD III-E, Inc.* v. *United States*, 459 F.3d 220 (2d Cir. 2006); *Long Term Capital Holdings v. United States*, 150 Fed. App'x 40 (2d Cir. 2005); *Aeroquip-Vickers, Inc.* v. *Commissioner*, 347 F.3d 173 (5th Cir. 2003), *cert. denied*, 543 U.S. 809 (2004).

[11] David Lupi-Sher, *Corporate Tax Shelters Regain Vitality*, 92 Tax Notes 11 (July 2, 2001) (internal quotation marks omitted); Karen C. Burke, Black & Decker *in the Fourth Circuit: Tax Shelters and Textualism*, 111 Tax Notes 315 (Apr. 17, 2006); Richard M. Lipton, *What will be the Long-Term Impact of the Sixth-Circuit's Divided Decision in* Dow Chemical?, 104 J. Tax'n 332 (2006); Craig W. Friedrich, *IRS Rebuffed in Three-Fold Attack on Aircraft Financing*, 32 J. Corp. Tax'n 36 (2005); Susan Simmonds, *Year In Review: Shelter Cases Highlight Uncertain Outcomes*, 109 Tax Notes 45 (Jan. 3, 2005); Nicholas Gunther, *Economics and* Compaq v. Commissioner, 97 Tax Notes 555 (Oct. 28, 2002).

confusion into the [tax] law." Dean Weiner & Christopher W. Campbell, *Right Results? Wrong Theories!* – Coltec Industries *and* Castle Harbour, J. Corp. Tax'n (forthcoming 2006). In particular, the Federal Circuit's narrow definition of the transaction that must be proven to have economic substance has an unsettling effect on tax planning:

> The problem for the rest of us is that any transaction that involves any tax planning at all has one or more aspects or elements that are tax motivated and serve no nontax purposes. . . .
>
> The *Coltec* court thus adds to the general confusion as about what the economic substance doctrine is, when and how it should be applied, and whether it has become an all-purpose talisman to be invoked by the court at its discretion in setting tax policy.

John F. Prusiecki, Coltec*: A Case of Misdirected Analysis of Economic Substance*, 112 Tax Notes 524 (Aug. 7, 2006); John F. Prusiecki, *Economic Substance – The Debate Rages*, 112 Tax Notes 1193 (Sept. 25, 2006); Sheryl Stratton, *Government, Tax Bar Disagree Over Impact of* Coltec, 212 Tax Notes 1 (Nov. 1, 2006).

Taxpayers need to predict *ex ante*, and with reasonable accuracy, the tax consequences of transactions they contemplate; doctrinal disarray is especially intolerable given the typically high financial stakes in transactions that the IRS seeks to disqualify. This Court should grant review to clarify the scope and validity of the economic-substance doctrine; resolve the circuit conflicts; and restore greater certainty to the administration of federal tax law.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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November 8, 2006

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
FEDERAL CIRCUIT

No. 05-5111

COLTEC INDUSTRIES, INC.,
Plaintiff-Appellee,

v.

UNITED STATES,
Defendant-Appellant.

July 12, 2006

Rehearing Denied Sept. 19, 2006

Before BRYSON, GAJARSA, and DYK, *Circuit Judges.*

DYK, *Circuit Judge.*

In 1996, Coltec Industries, Inc. ("Coltec") reported a capital loss of approximately $378.7 million on its consolidated tax return. This loss was generated by Coltec's selling of high-basis stock for a relatively low price. The Internal Revenue Service ("IRS") disallowed the loss and assessed additional taxes. Coltec paid the assessment and then filed a refund action for $82,803,049 in the United States Court of Federal Claims. That court awarded Coltec a full refund. The United States appealed. We conclude that, although Coltec's claimed capital loss fell within the literal terms of the statute, the transaction that created the high basis in the stock lacked economic substance and therefore must be disregarded for tax purposes. We vacate and remand for a recomputation of the allowable capital loss deduction.

BACKGROUND

I

In 1996 Coltec was a publicly traded company with numerous subsidiaries. In that year, Coltec sold one of its businesses, Holley Automotive, Inc., for a gain of approximately $240.9 million. Coltec then met with its tax advisors at Arthur Andersen LLP to discuss, among other things, strategies to offset this gain. *Coltec Indus., Inc. v. United States*, 62 Fed.Cl. 716, 723 (2004). Arthur Andersen proposed a transaction that had been used in the past to generate capital losses. The transaction essentially involved three steps. First, the parent company would reorganize a dormant subsidiary into a special purpose entity. Second, the parent would transfer property and contingent liabilities to the newly reorganized subsidiary in exchange for stock in that subsidiary. Finally, the parent would sell the stock to a third-party for a nominal sum. The parent would treat its basis in the stock as equal to the property it transferred to the subsidiary but not reduced by the liabilities the subsidiary assumed. The parent would then suffer a significant loss from the sale of the stock because the sale price of the stock would be drastically lower than its basis.

Coltec found Arthur Andersen's proposal appealing. For one thing, Coltec had contingent liabilities, namely asbestos liabilities, which were a prerequisite for this type of transaction. For many years, asbestos was widely used in the manufacture of a variety of products. *Coltec*, 62 Fed.Cl. at 718. Since the 1970s, however, manufacturers and distributors of asbestos products have faced a flood of claims from workers and other individuals who subsequently suffered from asbestos-related diseases. *Id.* at 719. This growing asbestos litigation had enormous implications for manufacturers and distributors dealing in asbestos products, costing these companies and their insurers billions of dollars and sending many into bankruptcy. *Id.* Coltec was at risk from

the asbestos problem, as one of its subsidiaries, Garlock, Inc. ("Garlock") and one of Garlock's subsidiaries, Anchor Packing Company ("Anchor") had both previously manufactured or distributed asbestos products. Indeed, by the early 1990s, Garlock and Anchor had been named defendants in 100,000 asbestos cases. *Id.* at 721. Corporate veil-piercing claims were not uncommon in asbestos cases.

Coltec decided to implement the Arthur Andersen proposal, and has admitted that tax avoidance was one of its reasons for doing so. Coltec's first step was to rename one of its dormant subsidiaries, Pennsylvania Coal and Coke, Inc., the "Garrison Litigation Management Group, Ltd." ("Garrison"). Coltec caused Garrison to issue 99,800 shares of common stock and 1,300,000 shares of Class A stock to Coltec in exchange for a payment of $13,998,000. In a separate transaction, Garrison issued 100,000 shares of common stock to Garlock (representing approximately a 6.6% interest in Garrison), and assumed all the managerial responsibilities for handling the asbestos related claims against Garlock. Garrison also assumed, and agreed to indemnify Garlock against, all losses and liabilities incurred in connection with asbestos-related claims against Garlock.[1] Garlock transferred to Garrison all outstanding Anchor stock, certain records and insurance policies relating to asbestos liabilities, and furniture. Garlock also transferred to Garrison a promissory note from one of its other subsidiaries, Stemco, Inc., in the amount of $375 million.[2] Garlock agreed to advance further funds as needed (up to $200 million) to cover Garrison's capital needs.

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[1] Garrison did not directly assume the asbestos liabilities of Anchor. However, Garrison did agree to indemnify Garlock from all future asbestos-related claims, which would include veil-piercing claims against Garlock based on Anchor's asbestos liabilities.

[2] Stemco was indebted to Garlock, but rather than have Stemco transfer the promissory note directly to Garlock, Garlock had Stemco transfer the note to Garrison. *See* J.A. at 7318-19; Coltec's Br. at 51. The reason for

Coltec explicitly admits that Garrison's assumption of the asbestos liabilities was in exchange for the Stemco note. Coltec's Br. at 39 ("Garrison received the Stemco note in exchange for assuming Garlock's asbestos liabilities."). In fact, the $375 million amount was calculated to cover the estimated future asbestos liabilities of Garlock, including the Anchor liabilities. Coltec obtained a range of liability estimates from the combined work of two consulting firms. The consulting firms estimated the projected gross future liabilities and the potential insurance coverage. One of the estimates provided by the firms was $371.2 million, which Coltec deemed to be a "high" estimate of the net future asbestos liabilities. Ultimately, the $375 million figure was adopted. *See* J.A. at 2302 (memo from Arthur Andersen to Coltec stating "[t]he settlement, judgment and litigation costs [of future asbestos related claims], net of [ ] assets and insurance coverage are currently estimated to be $375 million"). Thus, Garrison assumed responsibility for Garlock's potential asbestos liabilities in exchange for a promissory note in the amount of approximately $375 million.

The third and final step involved Garlock's sale of its newly-acquired Garrison stock. On December 20, 1996, as previously contemplated, Garlock sold all of its 100,000 shares of Garrison stock to two banks for $500,000. The amount received was only slightly greater than half the transaction costs for establishing Garrison. As a condition of this sale, Coltec agreed to indemnify the banks against any veil-

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utilizing a note from another entity was so that Garlock's basis in the note would be $375 million rather than zero. If Garlock had issued its own promissory note to Garrison, then Garlock's basis in that note would be treated as zero by the IRS because Garlock incurred no cost in making the note. *See* Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 3.06[4][b] at 3-35-3-36 & n. 127 (7th ed.2002).

piercing claims for asbestos liabilities. Coltec, after this transaction, continued to own 93% of Garrison.[3]

In its consolidated tax return for 1996, Coltec asserted that Garlock's basis in the Garrison stock was $379.2 million (representing the $375 million Stemco note plus the other property given to Garrison valued at approximately $4 million, but not reduced by the liabilities assumed by Garrison). Thus Garlock claimed to suffer a $378.7 million loss when it sold the stock for only $500,000. This $378.7 million loss more than offset Coltec's gains for that tax year. The unused loss was carried forward to offset gain in future tax years. Significantly, the loss was recognized only for tax purposes and not for book purposes, and the loss was not reported on the taxpayer's public financial reports.

II

Understanding how tax benefits could be claimed to result from this three-step transaction requires a review of the statutory scheme. It is undisputed that the underlying transaction between Garlock and Garrison—which resulted in Garlock's claiming a high basis in the Garrison stock—is governed by 26 U.S.C. § 351. Section 351(a) provides that certain transactions that involve controlled corporations will be tax-free. Specifically, when property is transferred to a controlled corporation solely in exchange for stock in that corporation, then in general no gain or loss is immediately recognized. 26 U.S.C. § 351(a) (1996).

The critical question here is the basis for the stock. In a simple property-for-stock exchange under § 351, § 358(a)(1) provides that the transferor's basis of the stock received will be equal to the basis of the property transferred. 26 U.S.C. § 358(a)(1) (1996). However, a transaction under § 351 can

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[3] Two years later, Coltec sold 45,000 of its Garrison shares to attorneys in regional defense firms involved in asbestos litigation.

become more complicated if, for example, in addition to receiving stock, "money" is also received from a controlled corporation. In such cases, the transferor's basis in the stock received is no longer simply equal to the basis of property transferred. Instead, the transferor's basis in the stock received is equal to the basis of the property transferred *decreased* by the "money received" by the transferor though increased by the amount of gain recognized. § 358(a)(1)(A). The central statutory dispute here is whether the assumption of Garlock's liabilities by Garrison constituted "money received" by Garlock. If it did, then Garlock's basis in the stock would have to be reduced by the amount of the liabilities assumed.

Under the tax code, "liabilities" that are assumed in a § 351 exchange generally must be treated as "money received" by the transferor for basis purposes. 26 U.S.C. §§ 358(a)(1)(A), 358(d)(1). However, § 358(d)(2) provides an exception to this general rule, excluding as "money received" for basis calculation purposes "the amount of any liability excluded under section 357(c)(3)." As will be explained in greater detail below, Coltec's primary theory is that Garlock did not have to decrease its basis in its Garrison stock by the amount of liabilities Garrison assumed, because these liabilities fell under the § 358(d)(2) exception and thus escaped "money received" treatment. On the other hand, the government contends that the § 358(d)(2) exception is not available to Coltec.

III

Upon audit, the IRS disallowed the $378.7 million loss and assessed a tax liability for the year 1996 in the amount of $82,708,152. Coltec paid the assessment and sued for a refund in the Court of Federal Claims. The government contended that the loss should be disallowed because Garlock was not entitled to the claimed basis for the Garrison stock. The government offered three separate theories. First, the government argued that the contingent asbestos liabilities

were not excluded from "money received" treatment by § 358(d)(2), because § 357(c)(3) was inapplicable, as it refers to liabilities which would "give rise to a deduction" and the contingent liabilities here would not "give rise to a deduction." Second, the government argued that the transaction in which Garlock transferred a $375 million note to Garrison in exchange for the assumption of the asbestos liabilities had an improper purpose and should thus result in "money received" treatment under the statutory anti-abuse provision.[4] Finally, the government argued that the transaction in which the note was exchanged for the liability assumption should be disregarded under the general economic substance doctrine with the result that the basis would not be increased by the amount of the Stemco note.

The Court of Federal Claims, after a bench trial, rejected the government's three arguments. The court held that the liabilities would "give rise to a deduction" under § 357(c)(3). *See Coltec,* 62 Fed.Cl. at 743-44.[5] The court also determined

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[4] The anti-abuse provision (26 U.S.C. § 357(b)(1)) provides:

> (1) In general.—If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—
>
> (A) was a purpose to avoid Federal income tax on the exchange, or
>
> (B) if not such purpose, was not a bona fide business purpose, then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall . . . be considered as money received by the taxpayer on the exchange.

[5] As an alternative ground for allowing the loss, the Court of Federal Claims held that Coltec was not required to reduce its basis in the stock by the amount of contingent liabilities, because the events necessary to establish the fact of the liability had not yet occurred. *Coltec Indus.*, 62 Fed.Cl. at 737-38. The court thus determined that "contingent liabilities" did not qualify as "liabilities" under § 358(d).

that that transaction should not result in "money received" treatment under § 357(b)(1), the statutory anti-abuse provision, because the principal purpose of the transaction was not tax avoidance; rather, it was a bona fide business purpose. *Id.* at 738-43. The Court of Federal Claims finally rejected the government's alternative argument under the general economic substance doctrine, concluding that the doctrine was unconstitutional as a violation of separation of powers. *Id.* at 756. The court went on to hold alternatively that the doctrine did not apply to the present case because the transaction had a bona fide business purpose. The government timely appealed. We have jurisdiction pursuant to 28 U.S.C. § 1295(a)(3).

DISCUSSION

We find nothing in the literal terms of the statute that required Garlock to reduce its basis in the stock by the amount of liabilities assumed by Garrison. However, we conclude that the Court of Federal Claims erred in rejecting the long-standing economic substance doctrine and in its application of that doctrine. The underlying transaction between Garlock and Garrison, in which a $375 million note was transferred to Garrison in exchange for the assumption of the contingent asbestos liabilities, had no meaningful economic purpose, save the tax benefits to Coltec. As such, that transaction must be ignored for tax purposes.

I

We turn first to the arguments based on the literal language of the code provisions. Section 358(a) provides that the basis of the property received in a tax-free exchange under § 351, i.e., the stock received by the transferor, "shall be the same as that of the property exchanged . . . decreased by . . . the amount of any *money received* by the taxpayer . . . ." 26

U.S.C. § 358(a) (emphasis added). Section 358(d)(1) further provides:

> In general.—Where, as part of the consideration to the taxpayer, another party to the exchange *assumed a liability* of the taxpayer . . . such assumption . . . (in the amount of the liability) shall, for purposes of this section, be treated as *money received by the taxpayer* on the exchange.

§ 358(d)(1) (emphases added). Thus, a liability transferred by the taxpayer is generally treated as "money received" when calculating the basis of the property received.

A

The Court of Federal Claims held that § 358(d) was inapplicable because "contingent liabilities" are not "liabilities" under the statute. We disagree. The fact that an obligation is contingent upon a particular condition (such as a successful suit in court) does not make that obligation any less of a "liability." Coltec argues that under *Brown v. Helvering*, 291 U.S. 193, 54 S.Ct. 356, 78 L.Ed. 725 (1934), contingent liabilities are not considered as liabilities for tax purposes. *Brown* and similar cases cited, in fact, assume that contingent liabilities are liabilities and address *when* a taxpayer can deduct a liability for income tax purposes, not whether a taxpayer who transfers a liability must adjust its basis in the property it received. *See Brown*, 291 U.S. at 200-01, 54 S.Ct. 356; *see also* 26 C.F.R. § 1.461-1(a)(2)(i) (1996) (providing that a liability is "incurred" in the taxable year in which all events have occurred to establish the fact of the liability).

It is widely recognized that when one party in an exchange assumes a contingent liability of another party, that contingent liability, like all other liabilities, forms an integral part of the purchase price in the exchange. *See, e.g., Ill. Tool Works, Inc. v. Comm'r of Internal Revenue*, 355 F.3d 997,

1003 (7th Cir.2004); *Holdcroft Transp. Co. v. Comm'r of Internal Revenue*, 153 F.2d 323, 324 (8th Cir.1946); *cf. United States v. Smith*, 418 F.2d 589, 592 (5th Cir.1969). That a contingent liability assumed by the transferee forms part of the purchase price paid by the transferee reveals that there is no meaningful distinction between contingent and non-contingent liabilities with respect to what is received (i.e., "money received") by the transferor. We conclude that "contingent" liabilities are "liabilities" under § 358(d). This conclusion is further supported by leading tax commentators.[6]

Consequently, under the general rule, the liabilities assumed by Garrison would be treated as "money received" by Garlock. Thus under the general rule, Garlock's basis in its

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[6] Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* (7th ed.2002), states:

> At the time of a § 351 exchange, it is not ordinarily necessary to determine whether a liability that is assumed by the transferee corporation or to which the transferred property is subject is too contingent to be taken into account or is instead fixed so as to qualify for the exemption of § 357(a); either way, it does not require the recognition of gain. *The debt must be properly classified, however, in applying §§ 357(b) and 357(c) (relating to tax avoidance transfers and debt-in-excess of basis, respectively.) If a borderline liability is sufficiently fixed for § 357(b) or § 357(c) purposes, then it would seem that the transferor should be required to reduce (or adjust) his basis in the stock received for the property under § 358(a)(1)(A)(ii).*

Id. at ¶ 3.10[3], at 3-60 (emphasis added, footnote omitted). *See also* Lee Sheppard, *Cognitive Dissonance on Contingent Liabilities in Asset Acquisitions*, 78 Tax Notes 142, 143-44 (1998), stating:

> [A] sound alternative to deferred purchase price adjustments is for the parties to estimate the contingent liabilities at the time of sale, with the seller taking the estimate into income and the buyer adding it to its basis in the purchased assets. This would allow the seller to walk away. Valuing contingent liabilities, although difficult, turns out not to be as difficult as incorporating those estimates into tax rules that are premised on precision and symmetrical results.

newly acquired Garrison stock would be decreased by the amount of the contingent liabilities assumed by Garrison.[7]

B

However, there is an exception to this general rule for calculating basis. Section 358(d)(2) provides that § 358(d)(1) "shall not apply to the amount of any liability excluded under section 357(c)(3)." Section 357(c)(3), in turn, states:

> If a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which . . . would give rise to a deduction . . . then, for purposes of [§ 357(c)(1)], the amount of such liability shall be excluded in determining the amount of liabilities assumed or to which the property transferred is subject.

The government asserts that the liabilities at issue do not fall under § 358(d)(2)'s exception. The government's argument requires that we consider the interaction of four code

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[7] Coltec also contends that the addition of § 358(h) to the tax code in 2000 supports its position that contingent liabilities are not "liabilities." Section 358(h) provides:

> If, after application of the other provisions of this section to an exchange or series of exchanges, the basis of property to which subsection (a)(1) applies exceeds the fair market value of such property, then such basis shall be reduced (but not below such fair market value) by the amount (determined as of the date of the exchange) of any liability—(A) which is assumed by another person as part of the exchange, and (B) with respect to which subsection (d)(1) does not apply to the assumption.

26 U.S.C. § 358(h)(1). Section 358(h) explicitly includes "contingent obligation[s]" as "liabilities" under that subsection. 26 U.S.C. § 358(h)(3). Coltec thus argues the inclusion of "contingent liabilities" in § 358(h) means that "contingent liabilities" are not included in § 358(d). However, § 358(h) by its own terms operates only when § 358(d) does not apply. Thus, we find § 358(h) to be of little utility in our analysis even if we were to assume that a 2000 amendment had interpretive value for construing the earlier code provisions involved here.

provisions: sections 358(d)(2), 357(c)(3), 357(c)(1), and 357(b)(1).

i. Application of § 357(c)(3)

In order to fall under the § 358(d)(2) exception, the language of § 358(d)(2) requires that the liability must be "excluded under section 357(c)(3)." The reference to § 357(c)(3) is somewhat odd because § 357(c)(3) is a provision relating to the calculation of *gain* rather than the calculation of *basis*, and the rules for gain recognition are themselves complex. Briefly, by virtue of § 351(a) and (b)(1), gain generally need not be recognized in an exempt transaction except to the extent of "money received." But, under § 357(a), "money received" generally does not include liabilities assumed. However, by virtue of § 357(c)(1), when liabilities exceed basis, gain must be recognized to that limited extent. Section 357(c)(3) excludes certain liabilities from subsection (c)(1). Nonetheless § 357(b)(1) provides that (c)(1) is inapplicable and the full amount of the liabilities assumed must be recognized as gain when the assumption of liabilities was principally for tax avoidance or lacked a bona fide business purpose.[8]

The parties first dispute whether the liabilities here "would give rise to a deduction" as § 357(c)(3) requires. The government contends that the liability is not the kind that "would give rise to a deduction" under § 357(c)(3) because § 357(c)(3) only applies where the transferor (here Garlock) transferred *both* a liability and the underlying business that generated that liability. Because Garlock transferred its asbestos liabilities but kept its core business, the government urges that the liabilities do not fall within the scope of § 357(c)(3). It is true that the central purpose of § 357(c)(3) was to protect taxpayers who transferred the assets of their business along with

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[8] Section 357(c)(2) states that § 357(c)(1) "shall not apply to any exchange . . . to which subsection (b)(1) of this section applies . . . ."

liabilities of their business (such as accounts payable) from having to recognize gain if the liabilities exceeded the assets. The theory was that the transferor corporation should not have to recognize gain when it had lost the tax deduction that would flow from payment of the liabilities. S.Rep. No. 95-1263, at 184-85 (1978). Section 357(c)(3) "rescue[s] the taxpayer[ ] from this harsh result" because the taxpayer would not be obtaining a tax benefit from the transfer of liabilities. Bittker & Eustice, ¶ 3.06[4][c] at 3-37 & n. 131; *see* S. Rep. 95-1263, at 185-85. However, we find the government's interpretation to be inconsistent with the plain language of § 357(c)(3). Nothing in the plain language of § 357(c)(3) limits the liabilities excludable to only those that were transferred along with an underlying business.[9]

Accordingly, we conclude that § 357(c)(3) does not limit excludable liabilities to only those that were transferred with an underlying business, and that the liabilities here satisfy the "would give rise to a deduction" requirement. In so holding, we join the only other court of appeals to have considered this exact issue. *See Black & Decker Corp. v. United States*, 436 F.3d 431, 437 (4th Cir.2006) ("The prototypical transaction Congress had in mind in drafting § 357(c)(3) may well have been one in which a corporation exchanged liabilities as part of a transfer of an entire trade or business to a controlled subsidiary, but nothing in the section's plain language embraces such a limitation.").

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[9] The government points to a statement in the legislative history of § 357(c) which states: "In general, liabilities the payment of which would give rise to a deduction include trade accounts payable and other liabilities (e.g., interest and trades) which relate to the transferred trade or business." S.Rep. No. 96-498, at 62 (1979). This statement of legislative history does not suggest that a transfer of a trade or business is a necessary element of the transaction; it merely explains that liabilities that relate to a trade or business are "include[d]" among the liabilities which would give rise to a deduction.

ii. Applicability of § 357(b)(1)'s Anti-Abuse Provision

Section 357(c)(3) states that if the liability qualifies, then "for purposes of [§ 357(c)(1)], the amount of such liability shall be excluded in determining the *amount of liabilities assumed* . . . ." (emphasis added). Section 357(c)(1) provides:

> Liabilities in excess of basis.—
>
> (1) In general.—In the case of an exchange . . . to which section 351 applies . . . if the sum of the *amount of the liabilities assumed,* plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

Id. (emphasis added). Basically, § 357(c)(1) sets forth a gain-recognition calculation where one of the variables is the "amount of liabilities assumed." Section 357(c)(3) excludes certain liabilities from this gain-recognition calculus.

However, § 357(c)(1) does not apply when an exchange triggers § 357(b)(1)'s anti-abuse provision. 26 U.S.C. § 357(c)(2). Section 357(b)(1)'s anti-abuse provision applies where liabilities are assumed principally for tax avoidance purposes or lack a bona fide business purpose:

> Tax avoidance purpose.—
>
> (1) In general.—If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—
>
> (A) was a purpose to avoid Federal income tax on the exchange, or

> (B) if not such purpose, was not a bona fide business purpose, then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351 or 361 (as the case may be), be considered as money received by the taxpayer on the exchange.

When it applies, the effect of § 357(b)(1) is two-fold. First, it supplants § 357(c)(1) and requires that assumed liabilities be treated as "money received" for purposes of § 351(b), so that the full amount of gain must be recognized to the extent of liabilities assumed rather than merely (as (c)(1) requires) the amount that liabilities exceed basis. Second, it eliminates the § 357(c)(3) exclusion. In other words, § 357(c)(3)'s exclusion may be rendered inapplicable by (b)(1) if there is a principal tax avoidance purpose or an absence of bona fide business purpose.

The government argues that the transaction here falls within § 357(b)(1) because the principal purpose behind the assumption of liabilities by Garrison was to avoid taxes or was otherwise not a bona fide business purpose. Although neither § 358(d)(2) nor § 357(c)(3) (the sections directly involved here) makes a direct reference to § 357(b)(1) (the anti-abuse provision), the government argues that: § 357(c)(3) refers to § 357(c)(1); § 357(c)(1) can only apply when § 357(b)(1) does not apply; and that therefore, § 357(c)(3) cannot apply where § 357(b)(1) applies.

We disagree with the government's construction of these code provisions. These code provisions are not a model of statutory draftsmanship. The real question is what is meant by § 358(d)(2) when it refers to a "liability excluded under section 357(c)(3)." This could have two possible meanings. It could mean that a liability is excluded "under section 357(c)(3)" if—looking at § 357(c)(3) in a vacuum—the liability is of the type excluded from the § 357(c)(1) calculation. On the other hand, it could mean that the liability is "ex-

cluded" only if it is actually excluded from gain recognition under § 357(c)(1) by operation of § 357(c)(3)—that is, if the (c)(3) exclusion is meaningful because § 357(c)(1) is operative and not overridden by § 357(b)(1). In essence, the taxpayer urges the former interpretation, and the government urges the latter interpretation. We think the taxpayer's interpretation is the better of the two.

In construing statutory provisions, we appropriately consult dictionaries in use at the time the statute was enacted.[10] *See, e.g., Amoco Prod. Co. v. S. Ute Indian Tribe*, 526 U.S. 865, 874, 119 S.Ct. 1719, 144 L.Ed.2d 22 (1999); *Am. Express Co. v. United States*, 262 F.3d 1376, 1381 n. 5 (Fed.Cir.2001). The use of the term "under" in § 358(d)(2) suggests limiting consideration to (c)(3) itself since the dictionary definition of "under" in this context is "required by" or "in accordance with." *Webster's Third New International Dictionary of the English Language Unabridged* 2487 (1976). In other words, the dictionary definition of the term "under" suggests looking only to the operation of § 357(c)(3) itself. The section says nothing about excluding liabilities from gain recognition. It deals only with excluding liabilities from the § 357(c)(1) computation. Moreover, we think that Congress likely would have done one of the following if it wished § 357(b)(1) to apply in this situation. On the one hand, it could have made explicit reference to the basis provision of § 358 in § 357(b)(1); instead that section refers only to treating an assumption of liabilities as "money received" for "purposes of section 351 or 361" (which deal only with gain recognition and not basis reduction). Alternatively, Congress could have made explicit reference to § 357(b)(1) in § 358(d)(2) if it intended to require that § 358(d)(2) apply only if § 357(c)(3)'s exclusion was not rendered inoperative by § 357(b)(1). In other words, if Congress wanted the operation of § 357(b)(1)

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[10] Paragraph 2 of § 358(d) was added to the statute by the Revenue Act of 1978, Pub.L. No. 95-600, § 365, 92 Stat. 2736, 2855 (1978).

to preclude the benefit of § 358(d)(2), it could have said in § 358(d)(2) something like, "§ 358(d)(1) shall not apply to the amount of any assumed liability excluded under § 357(c)(3) *unless the assumption involved a prohibited purpose described in § 357(b)(1).*" (The added underscored language would achieve the supposedly desired result.).

We thus conclude that if the liability is excluded by § 357(c)(3) standing alone, then § 358(d)(2)'s exception may be invoked. It does not matter whether the anti-abuse provision of § 357(b)(1) applies and overrides the actual operation of § 357(c)(1). The interpretation we adopt in this respect is identical to the interpretation adopted by the Fourth Circuit in *Black & Decker*, though we reach this result by a somewhat different interpretive path. We therefore conclude that the liabilities fall within § 357(c)(3); that § 357(b)(1) is not relevant here; and that § 358(d)(2) excludes the liabilities from "money received" treatment. The consequence is that under the literal terms of the statute the basis of Garlock's Garrison stock is increased by the Stemco note and is not reduced by the assumed contingent asbestos liabilities. Ultimately, the taxpayer would not be disqualified from claiming the capital loss.

II

Having concluded that Garlock's loss from the sale of its Garrison stock falls within the literal terms of the statute, we now turn to the government's argument under the general economic substance doctrine. We must first consider the Court of Federal Claims' holding that "the use of the economic substance doctrine to trump mere compliance with the Code would violate the separation of powers." *Coltec Indus., Inc.*, 62 Fed.Cl. at 756 (internal quotation marks omitted). That holding is untenable. In rejecting the economic substance doctrine, the court failed to follow binding precedent of the Supreme Court and this court and its predecessor court, the Court of Claims.

Over the last seventy years, the economic substance doctrine has required disregarding, for tax purposes, transactions that comply with the literal terms of the tax code but lack economic reality.[11] This principle has its roots in several Supreme Court cases. For example, in *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935), the Supreme Court disregarded a transaction which complied with the literal terms of the tax code, where the taxpayer, solely to avoid a dividend tax, caused her wholly-owned corporation to transfer stock to a new corporation which then transferred the stock directly to the taxpayer. *Id.* at 469-70, 55 S.Ct. 266. So too in *Commissioner of Internal Revenue v. Court Holding Co.*, 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981 (1945), the Supreme Court disregarded a transaction where the taxpayer, in order to avoid a large corporate income tax, transferred an asset in the form of a dividend to two shareholders who in turn conveyed the asset to a purchaser who had originally negotiated with the corporation to purchase the asset. *Id.* at 332, 65 S.Ct. 707. The Supreme Court has continued to embrace principles of economic substance in later cases. *See Knetsch v. United States*, 364 U.S. 361, 366, 81 S.Ct. 132, 5 L.Ed.2d 128 (1960) (disregarding a transaction where the taxpayers paid a "fee for providing the façade of 'loans' whereby the [taxpayers] sought to reduce their . . . taxes[,]" because "there was nothing of substance to be realized by [the taxpayer] from this transaction beyond a tax deduction"); *see also Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978) (allowing a transaction because there was "a genuine multiple-party transaction with economic substance which [was] compelled or encouraged by business . . . realities . . . and [was] not shaped solely by tax-avoidance features . . . .").

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[11] *See, e.g.*, Bittker & Eustice, ¶ 1.05[2]; Martin D. Ginsburg & Jack S. Levin, *Mergers, Acquisitions, and Buyouts*, ¶ 609.1 (2004); Jeff Rector, *Comment, A Review of the Economic Substance Doctrine*, 10 Stan. J.L. Bus & Fin. 173, 173 (2004).

The economic substance doctrine has also been repeatedly applied by our predecessor court. For example, in *Ballagh v. United States*, 166 Ct.Cl. 191, 331 F.2d 874 (1964), the Court of Claims disallowed a deduction for interest payments because the transaction which gave rise to the interest payment lacked economic substance as it did "not appreciably affect [taxpayer's] beneficial interest except to reduce his tax." *Id.* at 877-79. Likewise, in *Basic Inc. v. United States*, 212 Ct.Cl. 399, 549 F.2d 740 (1977), the Court of Claims disregarded an inter-company transfer of stock because the transfer had no purpose other than to give the parent a transferred basis in the stock, so that the parent could report less taxable gain on its subsequent sale of that stock. *Id.* at 745-46. *See also Rothschild v. United States*, 186 Ct.Cl. 709, 407 F.2d 404, 417 (1969). Further, our own cases have recognized the economic substance doctrine. *See Falconwood Corp. v. United States*, 422 F.3d 1339, 1349-51 (Fed.Cir.2005); *Terry Haggerty Tire Co., Inc. v. United States*, 899 F.2d 1199, 1201 n. 2 (Fed.Cir.1990); *Holiday Vill. Shopping Center v. United States*, 773 F.2d 276, 280 (Fed.Cir.1985). The various tax treatises also recognize the doctrine's continued viability.[12]

There can be no question that the Court of Federal Claims is required to follow the precedent of the Supreme Court, our court, and our predecessor court, the Court of Claims. *First Hartford Corp. Pension Plan & Trust v. United States*, 194 F.3d 1279, 1290 n. 3 (Fed.Cir.1999) ("[B]oth we and the Court of Federal Claims are bound by the decisions of the Court of Claims, this court's predecessor court."); *see also*

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[12] *See* Ginsburg & Levin, ¶ 609.1, at 6-205 ("[I]t is clear enough today that a reorganization must satisfy the business purpose requirement . . . ."); Bittker & Eustice at ¶ 1.05[2][b], at 1-21 ("It is often said that a transaction is not given effect for tax purposes unless it serves some purpose other than tax avoidance. The leading case in this area is *Gregory v. Helvering* . . . and the theory has had its fullest flowering in the area of tax law . . . .").

Strickland v. United States, 423 F.3d 1335, 1338 & n. 3 (Fed.Cir.2005).

Despite acknowledging that "the [Supreme] Court has decided tax cases invoking [the economic substance] doctrine," the Court of Federal Claims chose not to follow this precedent because "[a] careful reading of *other* cases cited by the Government[ ] . . . reveals that the Court resolved the tax question at issue first by looking to the Code and utilized doctrinal language only to further support its conclusion." *Coltec Indus., Inc.*, 62 Fed.Cl. at 753 (emphasis added). We fail to see how the existence of other Supreme Court cases that do not rely on the doctrine undermine the authority of those that do. The Court of Federal Claims also speculated that "the current vitality of the 'economic substance' doctrine certainly is not clear," *id.*, citing to *Nebraska Department of Revenue v. Loewenstein*, 513 U.S. 123, 115 S.Ct. 557, 130 L.Ed.2d 470 (1994). We do not read *Loewenstein* to be revisiting the validity of the economic substance doctrine. To the contrary, *Loewenstein* noted that "the substance and economic realities" of the transaction at issue supported the Court's conclusion that a trust received "interest" on cash lent to a seller. 513 U.S. at 134, 115 S.Ct. 557. Of course, even if the economic substance decisions of the Supreme Court have been eroded, the Court of Federal Claims would still be required to follow them as binding precedent. *Hohn v. United States*, 524 U.S. 236, 252-53, 118 S.Ct. 1969, 141 L.Ed.2d 242 (1998); *State Oil Co. v. Khan*, 522 U.S. 3, 20, 118 S.Ct. 275, 139 L.Ed.2d 199 (1997); *Rodriguez de Quijas v. Shearson/Am. Exp., Inc.*, 490 U.S. 477, 484, 109 S.Ct. 1917, 104 L.Ed.2d 526 (1989).

Even if we were to assume that the decisions of the Supreme Court and our predecessor court recognizing the economic substance doctrine are not binding, we cannot agree that the doctrine is somehow unconstitutional. Even Coltec makes no effort to defend this proposition on appeal. The

Court of Federal Claims has cited no authority supporting its determination that the doctrine is unconstitutional. The court cited only one case, *Seggerman Farms, Inc. v. Commissioner of Internal Revenue*, 308 F.3d 803 (7th Cir.2002), that even discussed the concept of separation of powers in light of the tax code, and that case simply suggested that separation of powers counsels against finding that a code provision exceeds Congress' taxing authority. *Id.* at 808 n. 8.

The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute. *See, e.g., Wisc. Dep't of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214, 230, 112 S.Ct. 2447, 120 L.Ed.2d 174 (1992) (noting that the maxim *de minimis non curat lex*—that "the law cares not for trifles" or extremely minor transgressions—"is part of the established background of legal principles against which all enactments are adopted"); *United States v. Native Vill. of Unalakleet*, 188 Ct.Cl. 1, 411 F.2d 1255, 1258 (1969) ("[W]e may at times construe a statute contrary to its 'plain language' if a literal interpretation makes a discrimination for which no rational ground can be suggested.").

The Supreme Court has explicitly held that when the judiciary goes beyond the literal language of a statute in order to give effect to its purpose, the separation of powers is not violated. In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 102 S.Ct. 1825, 72 L.Ed.2d 182 (1982), the Supreme Court considered whether the Commodity Exchange Act, 7 U.S.C. § 1 *et. seq.* (1976), which did not

explicitly create a private right of action, should be construed to create an implied private right of action to recover damages based on alleged statutory violations. *Id.* at 356, 369, 102 S.Ct. 1825. The petitioners argued that "the judicial recognition of an implied private remedy [would] violate[ ] the separation-of-powers doctrine." *Id.* at 376, 102 S.Ct. 1825. The Court explicitly rejected this argument, noting that:

> Courts . . . are organs with historic antecedents which bring with them well-defined powers. They do not require explicit statutory authorization for familiar remedies to enforce statutory obligations. A duty declared by Congress does not evaporate for want of a formulated sanction. . . . our function is to decide what remedies are appropriate in the light of the statutory language and purpose and of the traditional modes by which courts compel performance of legal obligations. *If civil liability is appropriate to effectuate the purposes of a statute, courts are not denied this traditional remedy because it is not specifically authorized.*

Id. at 376, 102 S.Ct. 1825 (emphasis added) (quoting *Montana-Dakota Co. v. Nw. Pub. Serv. Co.*, 341 U.S. 246, 261-62, 71 S.Ct. 692, 95 L.Ed. 912 (1951) (Frankfurter, J., dissenting)) (internal citations omitted). The Court went on to recognize an implied right of action under the statute, explaining that the statute was enacted in a legal context that historically recognized implied rights of actions. *Id.* at 375, 381, 102 S.Ct. 1825.

Here, the economic substance doctrine is merely a judicial tool for effectuating the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits not be afforded based on transactions lacking in economic substance. We conclude that there is no basis for holding the economic substance doctrine unconstitutional.

III

Although the Court of Federal Claims found the economic substance doctrine unconstitutional, it went on to hold that the doctrine was inapplicable in any event, relying on the findings that it made in connection with the statutory tax avoidance test. *Coltec Indus., Inc.*, 62 Fed.Cl. at 754. A review of that determination requires us to consider the basic principles of the economic substance doctrine, as well as its applicability to this case.

A. General Principles

The Supreme Court, various courts of appeals, and our predecessor court, have identified a number of different factors pertinent to the determination of whether a transaction lacks economic substance and thus should be disregarded for tax purposes. We understand the economic substance doctrine to incorporate the following principles.

First, although the taxpayer has an unquestioned right to decrease or avoid his taxes by means which the law permits, *Gregory*, 293 U.S. at 469, 55 S.Ct. 266, the law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality. This principle emerged early on in *Gregory*, where the Supreme Court disregarded intermediate transfers of stocks as falling outside the tax code because the transfers had "no business or corporate purpose" and performed no "function" other than to reduce taxes. 293 U.S. at 469, 55 S.Ct. 266. The Supreme Court later explained that "[if] . . . the *Gregory* case is viewed as a precedent for the disregard of a transfer of assets without a business purpose . . . it gives support to the natural conclusion that transactions, *which do not vary control or change the flow of economic benefits*, are to be dismissed from consideration." *Higgins v. Smith*, 308 U.S. 473, 476, 60 S.Ct. 355, 84 L.Ed. 406 (1940) (emphasis added). Our court and our predecessor court have followed a similar approach. *See Terry Haggerty Tire Co.*,

899 F.2d at 1201 n. 2; *Holiday Vill. Shopping Ctr.*, 773 F.2d at 280; *Basic Inc.*, 549 F.2d at 745-46; *Rothschild*, 407 F.2d at 417; *Ballagh*, 331 F.2d at 875-76. Several other courts of appeals have adopted similar positions. *See Dow Chem. Co. v. United States*, 435 F.3d 594, 599 (6th Cir.2006); *Boca Investerings P'ship v. United States*, 314 F.3d 625, 631 (D.C.Cir.2003); *In re CM Holdings, Inc.*, 301 F.3d 96, 102 (3d Cir.2002); *United Parcel Serv. of Am., Inc. v. Comm'r of Internal Revenue*, 254 F.3d 1014, 1018 (11th Cir.2001).

While the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance,[13] a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance.[14]

Second, when the taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance. In describing the history of the economic substance doctrine, our predecessor court in *Rothschild* stated, "Gregory v. Helvering requires that a taxpayer carry an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to the kind of transaction that would never occur absent the motive

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[13] *See, e.g., Dow Chem. Co.*, 435 F.3d at 599 (noting that a transaction that has economic substance may nonetheless be disregarded if the taxpayer had no subjective business profit motivation); Ginsburg & Levin, ¶ 609.1, at 6-205; *see also Frank Lyon Co.*, 435 U.S. at 583-84, 98 S.Ct. 1291 (holding that a transaction will be honored by the government where "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities . . . and is not shaped solely by tax-avoidance features").

[14] *See, e.g., United Parcel Serv. of Am., Inc.*, 254 F.3d 1014 (refusing to respect a transaction if it lacks economic effect). We think that the rule adopted by the Fourth Circuit and reiterated in *Black & Decker*—that a transaction will be disregarded only if it both lacks economic substance and is motivated solely by tax avoidance—is not consistent with the Supreme Court's pronouncements in cases such as *Frank Lyon*.

of tax avoidance." 407 F.2d at 411 (quoting *Diggs v. Comm'r of Internal Revenue*, 281 F.2d 326, 330 (2d Cir.1960)). Other circuits have similarly held that "[e]conomic substance is a prerequisite to the application of any Code provision allowing deductions [and therefore that] . . . [t]he taxpayer has the burden of showing that the form of the transaction accurately reflects its substance, and the deductions are permissible." *In re CM Holdings, Inc.*, 301 F.3d at 102.[15]

Third, the economic substance of a transaction must be viewed objectively rather than subjectively. The Supreme Court cases and our predecessor court's cases have repeatedly looked to the objective economic reality of the transaction in applying the economic substance doctrine.[16] While the taxpayer's subjective motivation may be pertinent to the existence of a tax avoidance purpose, all courts have looked to the

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[15] *See also Kirchman v. Comm'r of Internal Revenue*, 862 F.2d 1486, 1490 (11th Cir.1989); *Stewart v. Comm'r of Internal Revenue*, 714 F.2d 977, 990-91 (9th Cir.1983); *cf. Dow Chem. Co.*, 435 F.3d at 599.

[16] *See Gregory*, 293 U.S. at 469-70, 55 S.Ct. 266; *Frank Lyon Co.*, 435 U.S. at 584, 98 S.Ct. 1291; *see also Ballagh*, 331 F.2d at 875-78 (finding that where the taxpayer obtained a bank loan to prepay all his annual life annuity premiums, and then borrowed from the annuity company itself to pay back the bank loan, the loan payments to the annuity company were not deductible interest payments because that transaction did "*not appreciably affect his beneficial interest* except to reduce his tax") (emphasis added); *Rothschild*, 407 F.2d at 411, 414, 417 (describing the historic economic substance analysis as whether the transaction has "realistic financial benefit" and finding that where the taxpayer borrowed funds to invest in treasury notes with a lower interest rate than the borrowed funds themselves, taxpayer could not deduct interest payments on borrowed funds because "*there was neither a possibility nor opportunity of profit* to the taxpayer separate and apart from the tax deduction") (emphasis added); *Basic Inc.*, 549 F.2d at 745-47 (finding that where a parent company had its first-tier subsidiary distribute to it all the outstanding stock of a second-tier subsidiary so that the parent could directly sell the stock to a third party and realize less gain, the inter-company transaction should be disregarded because it had no "*valid business grounds* ") (emphasis added).

objective reality of the transaction is [sic] assessing its economic substance. *See, e.g., Black & Decker*, 436 F.3d at 441-42 (noting that economic substance inquiry requires an "*objective* determination of whether a *reasonable* possibility of profit from *the transaction* existed") (internal quotation marks omitted, first two emphases added); *Dow Chem. Co.*, 435 F.3d at 599; *In re CM Holdings, Inc.*, 301 F.3d at 103 (stating that the objective economic substance inquiry is "whether the transaction affected the taxpayer's financial position in any way"); *United Parcel Serv. of Am., Inc.*, 254 F.3d at 1018; *Rice's Toyota World, Inc. v. Comm'r of Internal Revenue*, 752 F.2d 89, 94 (4th Cir.1985).

Fourth, the transaction to be analyzed is the one that gave rise to the alleged tax benefit. For example, in *Basic Inc.*, where the taxpayer underwent an inter-company transfer of stock to allow the parent to sell the stock to a third party with little taxable gain, our predecessor court looked for the economic substance of the inter-company transfer of stock—not of the ultimate sale of stock to the third party. 549 F.2d at 745-46. The court explained that if the business purpose of the ultimate sale could be used to justify the unnecessary inter-company transfer, then "all manner of intermediate transfers could lay claim to 'business purpose' simply by showing some factual connection, no matter how remote, to an other-wise legitimate transaction existing at the end of the line." *Id.* at 745. Similarly, in *Ballagh*, where the taxpayer obtained a series of loans to prepay annual annuity premiums so that he could characterize his payments as deductible interest, the Court of Claims focused on the purpose for the loan from the annuity company—not the purpose of the initial annuity contract, when evaluating the economic substance of the transaction. 331 F.2d at 878. So also the Fourth Circuit has stated that in economic substance cases, the focus is on "the specific transaction whose tax consequences are in dispute," *Black & Decker*, 436 F.3d at 441, and the Second Circuit has stated that "[t]he relevant inquiry is whether the

transaction that generated the claimed deductions . . . had economic sub-stance," *Nicole Rose Corp. v. Comm'r of Internal Revenue*, 320 F.3d 282, 284 (2d Cir.2003). *See also ACM P'ship v. Comm'r of Internal Revenue*, 157 F.3d 231, 260 & n. 57 (3d Cir.1998). These cases recognize that there is a material difference between structuring a real transaction in a particular way to provide a tax benefit (which is legitimate), and creating a transaction, without a business purpose, in order to create a tax benefit (which is illegitimate).

Finally, arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny. The transaction in *Gregory* is illustrative. There, the Supreme Court found that the transfer of stock from a wholly owned corporation to a newly created corporation and then directly to the taxpayer, lacked economic substance because the "sole object and accomplishment of [the transfer] was the consummation of a preconceived plan, not to reorganize a business . . . but to transfer a parcel of corporate shares to the petitioner" in such a way as to avoid taxes. 293 U.S. at 469, 55 S.Ct. 266. Similarly, our predecessor court in *Basic Inc.* disregarded an inter-company transfer of stock whereby a subsidiary, "through its controlling parent, was caused to transfer the property whose sale the parent had decided upon for its own separate purposes." 549 F.2d at 746. The court found it noteworthy that the inter-company transfer was part of a transaction which "was a foregone conclusion that might just as well have been carried out in reverse order . . . ." *Id.; see also Frank Lyon Co.*, 435 U.S. at 575, 583, 98 S.Ct. 1291 (in holding that a "genuine multiple-party transaction" had economic substance, the Supreme Court distinguished more "familial" arrangements involving only two parties); *United Parcel Serv. Of Am., Inc.*, 254 F.3d at 1018-19 (finding that a transaction had economic substance because it created "genuine obligations enforceable by an unrelated party" that was not under the taxpayer's control).

B. Application of the Economic Substance Doctrine

Under these principles, Coltec had the burden of proving that this transaction, which admittedly had a tax avoidance purpose, had an economic reality. The Court of Federal Claims held that Coltec had met this burden. The ultimate conclusion as to business purpose is a legal conclusion, which we review without deference, and the underlying relevant facts are in large part undisputed.

In urging that the transaction had economic substance, Coltec focused particularly on its objective to make the company as a whole a more attractive acquisition target as well as on its objective to make other potential target companies view Coltec as a desirable acquirer. Coltec offered two arguments for why the liabilities-note transaction had economic substance in this context: (1) because the creation of Garrison to manage the asbestos liabilities would make Coltec more attractive and (2) because the transaction would add a barrier to veil-piercing claims against Coltec. Neither of these theories suggests that the transaction at issue has economic substance.

The first asserted business purpose focuses on the wrong transaction—the creation of Garrison as a separate subsidiary to manage asbestos liabilities. Coltec contends that the transaction had an economic purpose because, by having a separate corporation like Garrison manage Garlock's asbestos liabilities, Coltec became more attractive. The following colloquy with John Guffey, Coltec's CEO, is illustrative:

> Q. [Coltec's Counsel:] . . . "[W]hat [effect] if any did a separate corporation like Garrison to manage the asbestos liabilities have on your ability either to be acquired, Coltec be acquired or for Coltec to do the acquiring?"
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> A. [Mr. Guffy:] Oh, I think . . . that was a real plus to us. . . . [W]e could talk to the investment community about what we were doing with asbestos, how we were managing it, how we looked at quantifying it, what it

> meant to us in their time frame. . . . [h]aving a separate entity defining the management of it and having experts within that entity to define what they were doing about the management of it, I think proved to be a plus.

Coltec Indus., Inc., 62 Fed.Cl. at 739-40 (emphasis omitted). The Court of Federal Claims also found that "[T]he management and minimization of [the asbestos] liabilities were essential to the continued viability of Anchor and potentially Garlock. *Therefore, the conversion of these businesses into corporate form* was clearly to serve a *bona fide* business purpose." 62 Fed.Cl. at 743. (emphasis added) (internal quotation marks omitted).

The government does not dispute that the transfer of management activities may have had economic substance. Government's Br. at 42. The transfer of management activities, however, is not the transaction at issue. Here, just as in *Basic Inc.*, we must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale. That transaction is Garrison's assumption of Garlock's asbestos liabilities in exchange for the $375 million note. Coltec admits that "Garrison received the Stemco note in exchange for assuming Garlock's asbestos liabilities." Coltec's Br. at 39. It is this exchange that provided Garlock with the high basis in the Garrison stock, this exchange whose tax consequence is in dispute, and therefore it is this exchange on which we must focus.

The transfer of the liabilities in exchange for the note is separate and distinct from the fact that Garrison took a managerial role in administering the asbestos liabilities, as demonstrated by the fact that Garrison *managed* another entity's asbestos liabilities (Anchor's liabilities) without actually *assuming* Anchor's liabilities. The taxpayer has not demonstrated any business purpose to be served by linking Garri-

son's assumption of the liabilities to the centralization of litigation management.[17]

Coltec's second argument for why the transaction has economic substance—that the transaction was designed to strengthen Coltec's position against potential veil-piercing claims—focuses on the appropriate transaction but is also unavailing.[18] Coltec argues, and the Court of Federal Claims agreed, that the transfer of the liabilities for the note was designed to strengthen Coltec's core business from veil-piercing claims, because Garrison would serve as another corporate layer between asbestos claimants and Coltec. Coltec correctly points out that the asbestos liabilities of subsidiary companies such as Garlock frequently exceeded the assets of those companies, and that plaintiffs in asbestos liability cases routinely sought to pierce the corporate veil to reach the assets of parent companies. Understandably, this was a matter of considerable concern to parent companies such as Coltec. The problem is that there is no objective basis for

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[17] Coltec in its brief argues that "Garrison obtained the right to any 'upside' if the future asbestos liabilities turned out to be less than the High estimate at the time of the contribution . . . ." Coltec's Br. at 49. There is no indication that this was viewed as a business purpose at the time of the transaction. In any event, the nominal amount ($500,000) that the banks paid for the stock—a little more than half of the transaction costs—demonstrates that creating this supposed "upside" potential had no real-world appeal to potential purchasers. Coltec also argues that the transaction created other benefits such as allowing Garrison to recover legal costs from its insurers, to issue settlement checks more quickly, and to negotiate its own vendor contracts. All of these benefits, however, flowed from the creation of Garrison as a separate entity to *manage* the asbestos liabilities, not from Garrison's assumption of the asbestos liabilities themselves.

[18] Coltec also argues that the transaction had business purpose because it helped to facilitate the later sale of stock by Coltec to regional defense counsel. We agree with the Court of Federal Claims' determination on this issue—that this second sale of stock was too distant in time from the transaction to serve as a legitimate business purpose.

suggesting that the assumption of these liabilities by another subsidiary (in this case Garrison) would in any way ameliorate this veil-piercing problem.

In this respect, Coltec relied entirely on the testimony of various Coltec executives about the veil-piercing benefits that they perceived from the Garlock-Garrison transaction. For example, Timothy O'Reilly, who was the head of Garlock's Asbestos Litigation Department and later Garrison's president, explained:

> The principal motive [of the Garrison transaction] was a further building of the corporate veil, isolating the liabilities, getting the asbestos litigation management department or department into a separate subsidiary for the reimbursement possibilities from the insurance carriers . . . . And it was to create within Coltec the asbestos liability box.

J.A. at 7227. Joseph Andolino, Coltec's tax director, stated:

> I felt that incorporating the liability management activities would ameliorate some of the very serious and grave concerns we had about veil piercing. I felt that it added to the story that we had about isolating the liability from the operations of the company.

J.A. at 7040. Further, as the Court of Federal Claims explained, Coltec's CEO, John Guffey "testified that he would have approved the restructuring in any event because of the benefits of protecting the assets of Coltec and Garlock from veil piercing claims." 62 Fed.Cl. at 723.

These subjective views of Coltec's executives, even if credited, as they were by the Court of Federal Claims, are insufficient to establish economic substance. As we have discussed, economic substance is measured from an objective, reasonable viewpoint, not by the subjective views of the taxpayer's corporate officers. Looking at the transaction

objectively, there is no basis in reality for the idea that a corporation can avoid exposure for past acts by transferring liabilities to a subsidiary.

The transfer of the liabilities for the note could only strengthen Coltec's defense against veil-piercing if third parties would be obligated to pursue Garrison instead of Garlock. It is perfectly clear that the transaction had no such result. We are not aware of, nor has Coltec brought to our attention, any authority suggesting otherwise. Nor has Coltec pointed to testimony from any third party that there could be such a benefit. The Court of Federal Claims made no such finding, and even Coltec concedes that Garrison's assumption of Garlock's asbestos liabilities did not actually shield Garlock or Coltec from direct liability, conceding that "Coltec could not, of course, effect a release of Garlock's liabilities to third parties." Coltec's Brief at 15 n. 9.

Thus the transaction here could only affect relations among Coltec and its own subsidiaries—it has absolutely no affect on third party asbestos claimants. It simply made a corporate subsidiary a conduit for the payment of asbestos liability claims. As the Supreme Court held in a related context, "[a] sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." *Court Holding Co.*, 324 U.S. at 334, 65 S.Ct. 707.

Far from making Garrison more attractive to third party acquirers such as the banks here, the assumption of the asbestos liabilities made the Garrison stock less attractive. The banks were willing to acquire Garrison stock from Garlock only by establishing "separate subsidiaries to insulate their banking business from any potential veil-piercing claims" and they insisted on being indemnified by Coltec against veil-

piercing claims. *Coltec Indus.*, 62 Fed.Cl. at 728-29; *id.* at 750.[19] The banks also insisted on keeping the entire transaction confidential. *Id.* at 751.

We therefore see nothing indicating that the transfer of liabilities in exchange for the note effected any real change in the "flow of economic benefits," provided any real "opportunity to make a profit," or "appreciably affected" Coltec's beneficial interests aside from creating a tax advantage. *See supra.* Garrison's assumption of Garlock's liabilities in exchange for the Stemco note served no purpose other than to artificially inflate Garlock's basis in its Garrison stock. That transaction must be disregarded for tax purposes. When that transaction is disregarded, the basis in the Garrison stock is unaffected by the Stemco note/assumed liability exchange.

Coltec may nonetheless be entitled to a capital loss deduction because the value of the other property transferred (roughly amounting to $4 million) which formed the basis for the Garrison stock exceeded the sale price of the stock by the banks. We therefore vacate the judgment below and remand for a limited purpose—so that the Court of Federal Claims may determine whether Coltec is entitled to a partial refund based on the sale of stock with a basis of approximately $4 million for a price of $500,000.

CONCLUSION

For the foregoing reasons, the decision by the Court of Federal Claims is vacated and remanded for further proceedings in accordance with this opinion.

VACATED AND REMANDED

COSTS

No costs.

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[19] "[T]he banks sufficiently were concerned about veil piercing that they too formed separate corporations to insulate their main business and required further indemnification from Coltec." *Id.*

APPENDIX B

UNITED STATES COURT OF FEDERAL CLAIMS

No. 01-072T

COLTEC INDUSTRIES, INC.,

Plaintiff,

v.

THE UNITED STATES,

Defendant.

Oct. 29, 2004

OPINION

BRADEN, *Judge.*

Many years ago, the United States Supreme Court in *Atlantic Coast Line v. Phillips*, 332 U.S. 168, 67 S.Ct. 1584, 91 L.Ed. 1977 (1947), quoting from prior decisions of Justice Holmes and Judge Learned Hand, observed:

> As to the astuteness of taxpayers in ordering their affairs so as to minimize taxes we have said that 'the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it.' This is so because [there is no] 'public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions.'

Id. at 172-73, 67 S.Ct. 1584 (internal citations omitted). And, that is what happened in this case.

RELEVANT FACTS[1]

The Government describes this tax refund dispute as follows:

> Hoping to avoid tax on its substantial capital gains, Coltec [Industries, Inc.] adopted an off-the-shelf corporate tax shelter scheme developed by Arthur Andersen LLP . . . , which was designed to create an offsetting, artificial tax "loss"—without any corresponding economic loss—through a complex series of prearranged steps . . . that were intended to have no other material impact upon Coltec.

Gov't Post-Trial Memorandum at 1-2. The record presents a different picture.

A. Asbestos Litigation In The United States.

Asbestos was widely used in the manufacture of countless industrial, commercial, and household products for many years. TR 52-56; *see also* Stephen J. Carroll et al., *Asbestos Litigation Costs and Compensation: An Interim Report*, Rand Institute for Civil Practice 13-15 (2002) ("Rand"). In 1973, the United States Court of Appeals for the Fifth Circuit held that asbestos manufacturers had a duty to warn industrial insulation workers who came into contact with asbestos of the

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[1] The relevant facts recited herein were derived from the following portions of the record: Plaintiff's February 13, 2001 Complaint ("Compl."); Defendant's Exhibits ("DX"); Joint Exhibits ("JX"); Plaintiff's Exhibits ("PX"); Trial Exhibits ("TX"); Transcript of Trial Held May 3-7, 11-12, 14, and 17-18, 2004 ("TR"); Transcript of Oral Argument Held September 29, 2004 ("A-TR"). Certain testimony, exhibits, and argument currently are subject to a Protective Order issued by the court on August 11, 2004 during a telephone conference with the parties. Although the court considers none of the information contained in this Opinion and Partial Judgment to be confidential, the underlying documents will remain under seal until the court is able to design a procedure for making as much of the record as possible public.

dangers associated with the use of that product and that manufacturers and distributors of products utilizing asbestos could be held jointly and severally liable. *See Borel v. Fibreboard Paper Products Corp.*, 493 F.2d 1076, 1103 (5th Cir.1973) (Wisdom, J.), *cert. denied*, 419 U.S. 869, 95 S.Ct. 127, 42 L.Ed.2d 107 (1974); *see also* TX 6 at 5 & n.5. The tsunami of cases filed after *Borel* resulted in multi-million dollar jury damage awards, many of which included punitive damages. TX 6 at 5-6; TR 2380-83. As a result, the financial viability of companies that manufactured or distributed products utilizing asbestos, as well as their insurance companies, was placed in jeopardy. TX 6 at 5-6; TR 56-57; 635-36; 1584-85. By the end of 1982, over $1 billion had been spent on compensation and litigation expenses associated with over 21,000 asbestos liability claims, and three major corporations had filed for Chapter 11 bankruptcy protection, "identifying the costs of asbestos litigation as the principal reason for the filing." Rand, at 6.

Johns-Manville Corporation ("Johns-Manville") was one of these manufacturers. In the face of an estimated 35,000-180,000 potential asbestos claims, Johns-Manville filed for Chapter 11 protection in 1982. TX 10 at ¶ 5.2. The reorganization plan established a trust to pay future claimants, pursuant to an administrative schedule that estimated the liquidated value of the amount due for each claim. *See In Re Johns-Manville Corp.*, 68 B.R. 618 (Bankr.S.D.N.Y.1986), *aff'd in part, rev'd in part, Kane v. Johns-Manville Corp.*, 843 F.2d 636 (2d Cir.1988). When the Manville Trust was established in 1988, it was estimated that 87,000-100,000 new claims would be filed over the life of the Trust, which was funded with over $2 billion. TX 10 at ¶ 5.2. By the end of 1989, the Manville Trust received over 140,000 claims, and new claims were being filed at the rate of 17,000 per year. TX 10 at ¶ 5.2.

Within one year, not only did the number of claims exceed the projected total for the life of the trust, but the average settlement costs per claim were running 65% higher than projected. TX 10 at ¶ 5.2. By 1990, however, the solvency of the Trust was at risk, so United States District Court Judge Jack Weinstein ordered all payments to cease until a panel of independent experts could be appointed to develop a statistical model to project future claims to better estimate the potential for new claims and a new plan of reorganization could be proposed. PX 13, 18; TR 1587. At that time, the number of projected claims over the then projected life of the Trust (1990 through 2049) was estimated to be more than 365,000; triple the number projected in 1988. PX 18 at GEXP 07019; TX 10 at ¶ 5.2; *see also* PX 150 at BOA 815. The 1993 Manville Report projected that approximately 445,000 claims would be filed against the Manville Trust between 1990 and 2049. PX 13 at GEXP 06964. The 1994 Manville Report forecasted approximately 365,000 claims. TX 10 at ¶ 5.2; PX 18 at GEXP 06988; TR 1587. This Report warned, however, that the actual claims filed might depart up or down from the forecast by as much as 50%, and did not assign any probability of the likelihood that the "High" projection of the number of claims (365,000 x 1.5) would be exceeded. PX 18 at GEXP 7011; TR 1588-89.

The new plan proposed to pay claims at a rate of 10% of their liquidated value. *See In re Joint Eastern and Southern Districts Asbestos Litigation*, 878 F.Supp. 473 (E.D.N.Y.1995), *aff'd in part, vacated in part,* 78 F.3d 764 (2d Cir.1996). Payments were made at this rate for the next six years despite an increase in filing of new claims. In 1994, claims filed against the Manville Trust increased by 73% over the prior year. In 1995, they increased by another 77%. PX 150 at BOA 814; TR 1581-83. Compared with 1994, actual filings in 1995 increased by 188%. PX 150 at BOA 814; TR 1581-83, 1591, 1595. In 1996, filings against the Manville Trust again exceeded the amount projected. PX 18 at GEX P7019;

TR 1592-95. By 2000, actual claims filed increased to 449,000 or twice what was predicted in 1981. PX 18 at GEX P7019. Consequently, in 2001, the Manville Trust again was required to revise the 1994 forecast of 365,000 claims (1990-2049) by 72.6%, *i.e.*, up to 630,000. TX 10 at ¶ 5.5. As of July 2003, over 643,000 claims had been filed against the Manville Trust. TX 10 at ¶ 5.2.

The experience of Johns-Manville was similar to that of other manufacturers and distributors of asbestos products. PX 18; *see also* Rand, at 80. In the 1980's, sixteen companies filed for bankruptcy to protect their assets from increasing asbestos liability claims; in the 1990's, an additional eighteen companies filed; and from January 2000-Spring 2002, twenty-two other companies filed. Rand, at vii.

At the same time that asbestos manufacturers and distributors sought bankruptcy protection, many of their insurance companies became insolvent. In 1994, the United States insurance industry estimated the cost of past and future asbestos liabilities at $20 billion. PX 368; TX 6 at 9; TX 10 at ¶ 5.3. By 1996, that estimate was increased by 50% to $30 billion. TX 10 at ¶ 5.3. By 2000, the industry estimated the cost of past and future asbestos liabilities could reach $48 billion by 2003. PX 368; TX 6 at 9; TX 10 at ¶ 5.5; *see also* Rand, at 54 ("U.S. insurance companies . . . report that [they] have spent about $21.6 billion on asbestos claims through 2000 . . . [W]e believe foreign insurers have spent $8 to $12 billion through 2000, over half of which has been assumed by London.").

Seeking deeper pockets, asbestos plaintiffs began to assert corporate veil piercing claims designed to hold parent companies liable for the asbestos-related activities of their subsidiaries and/or successor companies. *See* Franklin A. Gevurtz, Corporate Law § 1.5, 70 n.1 (2000) ("GEVURTZ") ("[C]ourts pierce the corporate veil to impose liability for a corporation's debt upon . . . an individual controlling a corporation . . . or

corporations under common control with the debtor corporation.") (emphasis added); *see also* PX 365-66; TX 6 at 4-7; TR 2380-87. By 1996, at least nine companies that were defendants in asbestos litigation faced such claims and, in seven of those cases, the federal and state courts involved ruled that the corporate veil could be pierced. PX 365-66; TX at 5-6.[2]

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[2] *See, e.g., Baltimore v. Keene*, 6-6 Mealey's Litig. Rep. Asb. 41 (Md. Cir. Ct., Baltimore Co., Apr. 18, 1991) (holding that genuine dispute existed as to parent's control over subsidiary's asbestos activities); *Schmoll v. ACandS, Inc.*, 703 F.Supp. 868 (D.Or.1988) (finding parent company to be successor in liability to subsidiary organized solely to escape asbestos liabilities of predecessor); *Parker v. Bell Asbestos Mines, Ltd.*, No. 83-3289, 1986 WL 2894, 1986 U.S. Dist. LEXIS 28687 (E.D.Pa. Mar. 3, 1986) (allowing veil piercing where parent corporation controlled all significant financial and administrative actions of subsidiary); *Scharold v. GAF Corp.*, No. C-1-84-1062, 1985 U.S. Dist. LEXIS 23540 (S.D.Ohio Jan. 10, 1985) (finding that parent corporation controlled all of subsidiary's production-related decision-making); *Lloyd v. Pfizer, Inc.*, No. C-1-84-397, 1985 U.S. Dist. LEXIS 22557 (W.D.Ohio Feb. 15, 1985) (holding that subsidiary was merely an alter ego of parent corporation). The defendants in the *Baltimore* and *Scharold* cases share the same parent company, Turner & Newell, LLC.

In addition, although a United States Bankruptcy Court Judge found no basis to pierce the corporate veil, such claims were part of a reorganization plan settling the case. *See In re Hillsborough Holdings Corp. v. Celotex Corp.*, 197 B.R. 366, 369 (Bankr.M.D.Fla.1996) ("Under the [Veil Piercing Settlement Agreement], Walter Industries, the reorganized entity paid $375 million in cash and securities to the Celotex Settlement Fund, to be held in trust for the benefit of the asbestos-related personal injury claims in the Celotex reorganization."). Two other cases also were settled after a United States District Court held that assets fraudulently were transferred to subsidiaries to avoid payment of asbestos liabilities. *See In re W.R. Grace & Co.*, 18-12 Mealey's Litig. Rep. Asb. 14 (Bankr.D. Del. June 25, 2003) (approving a settlement where defendant funded its bankruptcy estate with $115 million one-time lump sum payment); *In re W.R. Grace & Co.*, 2-5 Mealey's Asb. Bankr.Rep. 2 (Bankr.D.Del. Nov. 29, 2002) (approving a settlement where the defendant paid claimants on behalf of predecessor corporation).

B. The Coltec Group.

In 1996, Coltec Industries, Inc. ("Coltec") was a publicly-traded holding company comprised of twenty-eight separate companies (hereinafter collectively "the Coltec Group") with net sales exceeding $1 billion and equity value of $1.5 to $2 billion. JX 85; TR 71; AR 160.

In 1976, Coltec acquired Garlock, Inc. ("Garlock"), a profitable corporation. JX 85 at GX 24406-07; PX 97 at COLT 18443; PX 448; TR 48-50, 257-58, 278. One of Garlock's companies, Garlock Mechanical Packing Company, had annual sales of approximately $250 to $300 million and manufactured industrial sealing products and expansion joints utilizing asbestos as a primary component in the manufacture of gaskets and in pump and valve packings. DX 44A; TR 48-52, 257. Another Garlock company, Stemco, Inc. ("Stemco"), manufactured products for trucks and other heavy automotive vehicles and had annual sales of approximately $80 to $100 million, but Stemco did not utilize asbestos in manufacturing any of its products. TR 49-50, 258, 454-55.

In 1987, Garlock acquired Anchor Packing ("Anchor"), a manufacturer and distributor of industrial gaskets, pump packings, valves, and mechanical seals. TR 50-52. Anchor did utilize asbestos in manufacturing these products. TR 50-53, 74-76, 257. In 1993, Coltec decided to discontinue Anchor's business operations. PX 10 at KC 03185. By 1996, Anchor's only assets were nearly depleted insurance coverage and a small building in Louisiana. TR 673-74.

In 2002, increasing concerns about veil piercing resulted in the Commonwealth of Pennsylvania enacting the "Fair Share Act" to prevent plaintiffs with asbestos claims "from gaining disproportionate recoveries against 'deep pocket' defendants, only minimally responsible for the plaintiff's injuries." "The Issue: Asbestos Litigation," Washington Legal Foundation (Spring 2003) ("WLF: Asbestos Litigation") at 8.

C. On April 1, 1992, The Coltec Group Established A Litigation Management Department.

By the early 1990's, Anchor and Garlock were or had been defendants in approximately 100,000 asbestos cases. TR 58-59, 773. Prior to 1991, asbestos claims against Anchor and Garlock primarily were handled by their insurance carriers. PX 6A-7; TR 60-62, 98-99, 773-74.

In March 1991, John Guffey was named President and Chief Operating Officer of the Coltec Group. TR 47, 59-60. Prior to that time, Guffey had been President of Garlock and therefore was familiar with the asbestos litigation. TR 59-60. During the mid 1970's, however, Guffey also served as a representative of Aeroquip Corporation at meetings of the Asbestos Textile Institute in Washington, D.C., where the health risks associated with asbestos were discussed. TR 54-59. In September 1991, Guffey assumed primary responsibility for reformulating Coltec's asbestos liability management strategy. JX 2; PX 8. Guffey was very concerned that Garlock did not have a long-term strategy for management of asbestos litigation, including dealing with potential veil piercing claims, and he did not want these issues to distract management or cause problems with the daily operations of Garlock or other Coltec Group companies. PX 9; TR 59-65, 636-38. Guffey believed that asbestos litigation issues needed to be assigned to a group dedicated exclusively to that function that was physically and otherwise isolated from other Coltec Group operational and management functions. JX 3-4; TR 59-61. In addition, Guffey wanted a more "hands on" and aggressive approach to controlling defense costs. TR 59-63. As one of his first priorities as CEO of Coltec, Guffey decided to create a unit within Garlock that would be solely responsible for managing asbestos litigation and relations with the insurance carriers (the "Asbestos Litigation Department"). JX 3-4; TR 59-63, 637-38. Timothy O'Reilly, an experienced asbestos defense litigator, was hired to head the

Asbestos Litigation Department, which became operational on April 1, 1992, and was located in Palmyra, New York, a mile away from Garlock's operations. TR 63, 631, 639-40, 774-76.

At the time O'Reilly joined Coltec, asbestos claims filed against Anchor were handled by seven or eight insurance carriers. TR 641. Within six months, Zurich, Anchor's primary carrier, exhausted its $6.5 million coverage. TR 643-44. Shortly thereafter, Liberty Mutual also exhausted its coverage of $19.5 million. *Id.* This alarming development motivated O'Reilly to organize a consortium of the four largest remaining insurance carriers, with which he would meet two or three times a week so "they wouldn't dissipate the funds so quickly." TR 644. During the next two years, O'Reilly undertook a systematic program to control Coltec's asbestos litigation exposure: *e.g.*, internal staff of lawyers and paralegals were hired and primary control of the litigation was taken in-house; a database of the claims filed against Garlock and Anchor was created to monitor the status of those cases; the number of outside defense firms was reduced and their fees were cut 5% across the board; a roster of expert witnesses was developed; communication with Garlock's insurance carriers was improved to facilitate the recovery of Garlock's costs; and communication with the plaintiffs' bar was improved to reduce costs and facilitate settlements. JX 8; PX 17; TR 104-06, 639-59, 743-46, 776-91, 908-09. In addition, O'Reilly implemented procedures so that claims could be submitted directly to him for reimbursement without necessitating a court filing. TR 105-06; 789-90. O'Reilly also negotiated "buy-back" agreements with several of Anchor's insurers. TR 641-45. Centennial paid Anchor a lump sum of $27 million, and INA paid $9,750,000 to settle all existing and future asbestos claims and cancelled their policies. PX 11; TR 645. O'Reilly put these proceeds aside in "trust" and used them to satisfy future Anchor judgments, settlements, and associated defense costs. TR 645-46. In

addition, by June 1995, O'Reilly was successful in persuading ten of Garlock's twenty-eight carriers to cover a portion of the Asbestos Litigation Department's costs, by threatening to turn the Department into a law firm. PX 26 at COLT 16005-06; TR 659-66, 791-93, 803-05.

D. By June 6, 1996, The Coltec Group Decided To Establish A "Case Management Subsidiary."

1. Deliberations Of Management.

From May 1995 until the Coltec Group was sold in 1999, Joseph Andolino, an Officer and Vice President of the Coltec Group, had responsibility for industrial operations, business development, and a variety of overall corporate issues, including tax. TR 133-35. Andolino had frequent discussions with Coltec senior management about the uncertain and growing asbestos liability situation. TR 140-44.

Late in 1995, Andolino convened a meeting at Coltec's offices with Arthur Andersen, Coltec's accounting firm and auditor, to discuss overall tax planning. TR 145-46. Among the issues Andolino asked Arthur Andersen to explore were "mixing bowl partnerships and Morris Trust-type transactions so that we could get up to speed on current rules associated with those transactions[.]" TR 146. Andolino also wanted to discuss an anticipated $240 million of capital gain that Coltec might realize if and when Holley Automotive was sold, which Andolino stated he "was setting about ways to mitigate[.]" TR 146; *see also* JX 11-12, 17. The discussion at the meeting revealed that the Morris Trust and "mixing bowl" partnership options did not "fit" Coltec's purposes. TR 149.

As that meeting was ending, an Arthur Andersen partner mentioned to Andolino that he was aware that Coltec had significant contingent liabilities and knew of a transaction that another company had undertaken wherein contingent liabilities were transferred into a "litigation management activity fund." TR 150. Andolino remembered that "there

was a tax benefit associated with it." TR 150. Andolino saw this option as an opportunity to remove O'Reilly and his staff from Coltec's payroll and out of a building leased by Coltec, which Andolino thought would be beneficial because "there were grave concerns about veil piercing [a]nd it seemed to me that such a restructuring would put a certain orderliness to our corporate affiliates in such a way that it would ameliorate those concerns." TR 152, 361-62. Andolino also concluded that this type of transaction would be of particular interest to Guffey since it was consistent with Coltec's ongoing strategy "to isolate the asbestos problem." TR 151.

Andolino next met with Coltec officers and senior managers, including Guffey and O'Reilly, to discuss this proposal. TR 152-53, 157-59. Andolino retained the law firm of Kronish Lieb Weiner & Hellman ("Kronish Lieb") to provide legal advice. TR 153, 362.[3] In turn, Kronish Lieb retained Arthur Andersen to preserve and extend attorney-client privilege to Arthur Andersen's work product. DX 191; TR 153-54, 362-64. At trial, Andolino candidly admitted: "[A]lthough

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[3] It appears that this was indeed a busy time for Mr. Turlington, one of Coltec's counsel from Kronish Lieb. *See Long Term Capital Holdings v. United States*, 330 F.Supp.2d 122, 142 (D.Conn.2004) ("In early 1996, . . . B & B [an investment banking firm in the business of asset-based financing] approached Donald R. Turlington . . . who served as regular tax counsel to Long Term in the mid-1990's. [B & B] discussed with Turlington the potential placement of preferred stock with high basis . . . [B & B] agreed, that if Turlington assisted in the placement of the stock, B & B would compensate Turlington with a percentage of the profits B & B earned from the placement. Shortly [thereafter,] Turlington approached [Long Term] about an idea involving preferred stock he thought might be beneficial . . . Turlington summarized a transaction in which an investor that owned a security with a tax basis higher than the value of the security would contribute the security to [Long Term] in exchange for a partnership interest and, if [Long Term] subsequently were to purchase the investor's partnership interest before Portfolio sold the contributed securities, the tax law would permit 'the tax deduction[.]'") The United States District Court in *Long Term* disallowed the deduction in that case.

my belief was that [the Garrison transaction] was properly taken, I also realized that I could be wrong. It is a novel matter of first impression. I couldn't find any precedent. So as I thought about it, I don't know that I anticipated litigation, but I anticipated an examination. It is a large number. And my expectation was that the Internal Revenue Service might disallow it." TR 363-64; *see also* JX 14-15.

Although Andolino informed Guffey of the potential tax benefits, Guffey testified that he would have approved the restructuring in any event because of the benefits of protecting the assets of Coltec and Garlock from veil piercing claims. TR 86-87. The new and separate corporation would have its own budget, financial books, negotiate its own service contracts, and maintain control over issuance of settlement checks. TR 68-73, *see also* TR 686-87, 710-11, 904-05, 1150. Guffey believed that the proposed transaction could further achieve operational objectives that he had been pursuing since he became President and CEO of the Coltec Group, as well as be helpful in recovering the costs of litigation management from Garlock's insurers. TR 68, 87, 159-63, 803-05. O'Reilly concurred in Guffey's decision to create a separate litigation management company, primarily because it would help O'Reilly better identify and allocate costs so that additional insurance carriers might agree to contribute to the costs of managing Garlock and Anchor asbestos liabilities and potentially focus plaintiffs' attorneys on one pocket for recovery. TR 163-65, 685-91, 711-13, 803-05, 1150, 1186-87; *see also* TR 68-70. O'Reilly testified that he also appreciated that placing the asbestos liabilities into a separate corporation could only help improve efforts to maintain Garlock's and Coltec's separate corporate identity to avoid "veil piercing" claims. TR 686, 711. The sale of the litigation management company's stock to financial institutions, with which Coltec had or may have a relationship, was not one of the factors that Guffey or O'Reilly initially considered. TR 73-74. Both, however, saw a potential opportunity to

align the financial interests of outside defense counsel more closely with Coltec, if they purchased stock in the litigation management company. TR 73-74. For all of these reasons, Guffey authorized Andolino to proceed with development of the proposed reorganization, subject to continued consultation. TR 86-87, 153, 157-58, 162-63, 685, 803-05.

On April 29, 1996, Coltec's Senior Vice President and CFO circulated a memo to Andolino summarizing the proposed "case management subsidiary" and impact on the Coltec Group:

> Overall, the objectives for Garlock Case Management include first, the segregation and focus of asbestos claims management and second, to provide equity-like financial incentives directly and indirectly to certain of those persons involved in impacting the contingent asbestos exposure.

PX 45 at COLT 18104; TR 190-96.

On May 2, 1996, Coltec senior management and representatives from Kronish Lieb and Arthur Andersen first met to discuss formation of a "case management subsidiary." TR 365-66; DX 194. Other working meetings were convened on May 30, 1996 and August 8, 1996. TR 552-53; DX 202, 325.

In June 1996, Coltec sold Holley Automotive to Borg-Warner Automotive, Inc. for $283 million. JX 30; PX 43-44, 53.

2. Outside Consulting Firms Were Retained To Estimate Garlock's And Anchor's Contingent Asbestos Liabilities.

It was very important for Coltec to establish a liability management company that was capitalized with sufficient assets to pay anticipated future net asbestos liabilities after insurance. TR 691; *see also* Gevurtz § 1.5, at 91 (citing Robert B. Thompson, "*Piercing The Corporate Veil: An Empirical Study*," 76 Cornell L. Rev. 1036, 1066 (1991)

(concluding that courts pierced the corporate veil between seventy and seventy-five percent of the time when they found inadequate capitalization.)). Although O'Reilly and the Asbestos Litigation Department initially made some rough estimates of Garlock's and Anchor's contingent asbestos liabilities [TR 691-701], Tillinghast Towers-Perrin ("Tillinghast"), an international consulting firm that specializes in the analysis and projection of asbestos and pollution liabilities, was hired in May 1996 to conduct a professional analysis. TX 4 at ¶¶ 1.1-1.3; JX 16, 19, 21; PX 71, 363; TR 197-98, 250, 494-98, 525-27, 533, 691-702.

First, O'Reilly provided Tillinghast with several years of asbestos litigation data, including detailed information concerning claims filings, settlements, dismissed cases, and outside legal expenses for Anchor and Garlock. PX 52; DX 74; TR 495-98, 554-55, 702. Then, Tillinghast prepared various estimates of future Anchor and Garlock asbestos liabilities, on a gross basis, not taking into account the extent of insurance coverage. DX 166; PX 55-56, 66, 78; TX 4 at ¶¶ 4.1-4.6, 6.1-7.3; TX 5 at ¶¶ 11-20; TR 491-508, 608-25. In preparing these estimates, Tillinghast utilized different variables, including estimates of projected asbestos claims of the 1994 Manville Trust. PX 78 at DTP 2506-10; TX 4 at ¶¶ 5.1-7.2; TR 513-14, 1584-90. After adjusting those projections to account for the difference in the number of claims filed in the past against the Manville Trust and Garlock/Anchor, Tillinghast decided to use the 1994 Manville Trust Report as the basis for its projections of future filings against Garlock/Anchor. TX 4 at ¶¶ 5.1-5.5; PX 78 at DTP 2506.

Because of the volatile nature and inherent difficulty of estimating future asbestos liabilities and knowing that past estimates proved to be highly inaccurate, Tillinghast decided it was more reasonable to calculate a range of estimates of Garlock's and Anchor's estimated contingent asbestos liabil-

ities, rather than submit a single projection. TX 4 at ¶¶ 7.2-7.3; PX 55, 78 at DTP 2509-10; TR 579-80. Using three of nineteen potential scenarios, Tillinghast calculated "Low," "Medium," and "High" estimates of potential gross liabilities. TX 4 at ¶ 7.3; PX 55, 66, 78 at DTP 2503, 2514-15, 2520; TR 500-03, 535-38, 567-75, 600-01. No probabilities were assigned to the likelihood that the actual gross liabilities facing Anchor and Garlock would turn out to be lower than, equal to, or greater than any of these projections. TR 509, 541. On May 30, 1996, the preliminary results of Tillinghast's work were presented to Coltec. TR 548-50. Coltec's management was surprised the estimates were so high. TR 552-54, 566-67.

Tillinghast's estimates of gross liabilities, however, did not take into account the extent of insurance recovery, which was performed separately by another outside expert, Kahn Consulting, Inc. ("Kahn"). PX 358; TX 4 at ¶ 7.1; TX 5 at ¶¶ 3, 11; TR 510, 608. Kahn had worked with Coltec since 1990 on a variety of other assignments relating to insurance coverage. TX 5 at ¶ 3; TR 811. Since Garlock had "more than 30 insurance companies providing coverage with some years having more than 35 different policies in effect and a total of approximately 236 policies in effect between 1976 and 1984," it was important to determine which policies should be applied to specific claims. Many of the policies treated the payment of defense costs as distinct from indemnity payments. TX 5 at ¶¶ 6, 8. In connection with this work, Kahn developed a methodology for determining how the multitude of insurance policies issued by numerous carriers should be applied to Garlock's asbestos liabilities. TX 5 at ¶¶ 3-4, 8-9; JX 20, 23, 25; PX 19-20. Kahn developed a computer model to apply this methodology, named the "Rising Water Allocation Model." TX 5 at ¶¶ 3-4, 8-9; JX 20, 23, 25; PX 19. This Model also was used to generate invoices for the various insurance carriers concerning the amount of reimbursements owed to Garlock. TX 5 at ¶ 10.

In June 1996, Tillinghast provided Kahn with the "Low," "Medium," and "High" revised undiscounted cash flow projections of Anchor's and Garlock's gross contingent asbestos liabilities that showed, on an annual basis, the dollar amounts for settlements and defense costs through 2056. DX 166; PX 55; TR 500-05, 610-14. Kahn then input these projections into the "Rising Water Allocation Model" and computed the projected amounts of asbestos-related costs that would, or would not, be covered. PX 55; TX 5 at ¶¶ 8-15; TR 610-25. Kahn also "present valued" Garlock's net future asbestos liabilities with "Low," "Medium," and "High" estimates, at various rates ranging from 3% to 8%. TX 5 at ¶¶ 16-18.

On or about July 17, 1996, Kahn issued a draft report estimating the insurance coverage that might be available for the years 1976-1983. JX 24; TX 5 at ¶ 19; TR 612. It did not, however, address the issue of the collectibility of the projected insurance reimbursement, because it was assumed that the carriers that were solvent as of July 1996, would pay their policy obligations in full. JX 64 at BA 962, 965; PX 78 at DTP 2499; TR 510-11, 621-22. To the extent that carriers became insolvent, or chose to contest coverage, the amount of insurance coverage would be reduced, and Garlock's net uninsured liability would be higher than what Kahn projected. PX 78 at DTP 2499. Coltec was particularly concerned that policies issued by Royal Insurance for the period July 1983-July 1984, in the amount of $254 million, might not be paid because of the questionable financial condition of that insurance company. JX 24 at COLT 30517; TX 5 at ¶ 19; TR 612-13. Therefore, Coltec asked Kahn to re-project the net liabilities for the "High" estimate, assuming 80% coverage, which Kahn did by a July 19, 1996 letter, in which the net contingent liability under the "High" estimate decreased by approximately $119 million (on an undiscounted basis) and $8 million (discounted at 7%) from the estimates in the July 17, 1996 draft Kahn Report. JX 24 at COLT 30522; JX 26 at KC 07561; TX 5 at ¶¶ 19-20; TR 614-16.

The July 17, 1996 Kahn Report, as revised, was provided to Tillinghast, which incorporated Kahn's conclusions into an August 14, 1996 Report (the "Tillinghast Report"). PX 78; TX 5 at ¶¶ 19-20. The Tillinghast Report set forth the results of the present-value calculation, determining that discounting the net liability estimates at 5%, 6% and 7% was considered reasonable. PX 78, PX 145 at BA 1053, PX 150 at BOA 818; TX 5 at 3-11; TR 617-18, 1545-47, 1600-01, 1701, 1733-34. The Government's expert, P.J. Eric Stallard, one of the co-authors of the 1994 Manville Trust Report, testified that the "Low," "Medium," and "High" estimates, set forth by the Tillinghast Report, "were reasonable projections" of the combined Garlock and Anchor uninsured asbestos liabilities. TR 1733-34.

Based on the Tillinghast and Kahn Reports, Garrison was capitalized with assets estimated to be reasonably sufficient to cover the "High" estimate of net liabilities (after insurance coverage), with a present value discount rate of 7%, *i.e.*, or $371.2 million. JX 26 at KC 07561; PX 78 at DTP 2513; TR 200-01. Given the nature of the liabilities at issue and the difficulty of predicting future asbestos litigation, however, Tillinghast's Report included the following caveat:

> The technological, judicial, and political climates involving toxic torts such as asbestos are changing, and historical data cannot be used for standard actuarial projections. As a result, any projection of liabilities for asbestos is subject to much greater uncertainty than would normally be associated with a review of reserves for general and products liability exposures other than asbestos claims. We have conducted our review based on a variety of assumptions which are subject to change. While we believe that the methods and assumptions we have used to project asbestos contingent liabilities are reasonable at this time, it is important to understand that

they are likely to change as more information becomes available.

PX 78 at DTP 2498.[4]

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[4] In fact, Anchor's and Garlock's financial exposure was underestimated. PX 78 at DTP 2907; PX 491 at ROC 24752; TR 2707-08; *see also* Rand, at 15 (emphasis added) ("We have not been able to find any epidemiological study that has systematically investigated asbestos exposure and asbestos-induced disease that includes all industries and corporations in the U.S., although some analysts have examined patterns of legal claiming by industry. Although some studies project cases of disease, not deaths, *no study has provided a reliable estimate of how many people are sick at a given point in time as a result of occupational exposure to asbestos.*").

In 1995, claims exceeded the Tillinghast "High" projection by approximately 15% for lung cancer, 10% for mesothelioma, and over 100% for non-malignancies. PX 373-75; TX 7 at ¶ 34. Tillinghast, however, treated this as an aberration, and assumed that filings thereafter would return to the projected levels. PX 78 at DTP 2907; TX 10; TR 2707-08.

In 1996, actual filings against Garlock exceeded 50,000 or almost double the Tillinghast projection of 24,263. PX 78 at DTP 2907; PX 491 at ROC 24752; TR 2707-08.

In February 1997, Tillinghast issued a revised report that projected the gross contingent asbestos liabilities arising from claims against Garlock, as of December 31, 1996, at: $1.28 billion "Low;" $1.53 billion "Medium;" and $1.98 billion "High." PX 181 at DTP 2982; PX 446; TR 517-19. In August 1997, a revised report was issued showing claims against Anchor as of April 30, 1997, at: $196 million "Low;" $290 million "Medium;" and $364 million "High." PX 195 at DTP 3239, PX 445, 446; TR 518-19.

On December 13, 2000, Tillinghast projected the claims against Anchor as: $163.4 million "Low;" $293.9 million "Medium;" and $325.6 million "High." PX 294 at COLTEC 011250; PX 295 at COLTEC 010956; PX 445; TX 4 at ¶¶ 5, 8; TR 521. Garlock and Anchor combined estimated gross future liabilities increased in the "Low" category from $1.202 billion to $1.985 billion, in the "Medium" category from $1.598 billion to $2.619 billion, and in the "High" category from $2.234 billion to $3.091 billion. PX 445, 446.

In December 2000, Tillinghast performed another set of estimates of the gross future asbestos liabilities of Garlock and Anchor using sub-

E. On September 13, 1996, The Garrison Litigation Management Group Commenced Operations.

On June 6, 1996, before the Kahn Report was completed, a corporate decision was reached in Coltec to establish a "case management subsidiary." JX 18 at 5-6. Within a month of the issuance of the Kahn Report, all of the steps to implement this subsidiary were ready to be executed.

Coltec owned all the outstanding stock of Pennsylvania Coal and Coke, Inc., which previously had discontinued business operations, but was still obligated to pay out "black lung" benefit payments. PX 448; TR 259. On July 25, 1996, the name of PCC was changed to Garrison Litigation Management Group, Ltd. ("Garrison"). PX 69, PX 97 at COLT 18386-88, PX 143; TR 260.

To effect capitalization of Garrison, Garlock caused Stemco to issue an August 1, 1996 promissory note to Garlock in the amount of $375 million (the "Stemco Note"), for slightly more than the Tillinghast/Kahn "High" estimate, with interest payable quarterly at an initial rate of 8.25%, adjustable quarterly to the prime rate, and a maturity date of August 1, 2011. JX 26 at KC 07561, 27, 40; PX 78 at DTP 0002513; TR 250-54, 264-65. The "High" estimate was selected because Coltec was aware that the asbestos liability estimates relied on by the Manville Trust were greatly underestimated, and it was in Coltec's interest to fund Garrison on a conservative basis. TR 250-51. Of the $375 million principal amount, approximately $263 million was issued in satisfaction of an existing intercompany loan that Stemco owed to Garlock. JX

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stantially the same methodology as in 1996. PX 294-95, 445-47; TX 4; TX 5 at ¶¶ 21-26; TR 521-22, 604-05, 616-21. Tillinghast estimated Garlock's gross future liabilities increased in the "Low" category from $990 million to $1.821 billion, in the "Medium" category from $1.321 billion to $2.325 billion, and in the "High" category from $1.540 billion to $2.765 billion. PX 295 at COLTEC 01954; PX 445; TX 4 at ¶¶ 5, 8.

13 at AA 015019; PX 328, 449; TR 168-71, 265. The $112 million balance was made as a "distribution" to Garlock as Stemco's sole shareholder. JX 13 at AA 015019; PX 328, 449; TR 168-71, 265.

To assure that Stemco would have sufficient assets and operating cash to meet its obligations under the note, an intercompany payable in the amount of $314,781,121, owed by Garlock to Stemco was converted into a demand promissory note in that amount on August 31, 1996 (the "Garlock Note"). JX 28 at COLT 22444-46, JX 29; TR 265-68. The Garlock Note bore interest at a rate of 8% per annum and was payable on demand, which was to occur no later than August 31, 2011. JX 28 at COLT 22444. When demand for payment of any portion of principal was made, the interest rate increased to 10% per annum of the outstanding principal amount. *Id.* In the event demand for the principal was made, accrued interest was payable on demand. JX 28 at COLT 22444. The Garlock Note also contained a provision requiring Garlock to pay all litigation costs associated with enforcing the note in case of default. JX 28 at COLT 22445. The Stemco Note and Garlock Note were issued contemporaneously. DX 685; PX 97; TR 260, 262-63.

On August 27, 1996, Garrison's charter was amended to authorize issuance of 300,000 shares of common stock and 1,500,000 shares of Class A stock. PX 97 at COLT 18394; TR 260-62. On September 13, 1996, pursuant to a Stock Purchase Agreement, Coltec contributed $998,000 to Garrison in exchange for 99,800 shares of Garrison common stock ($10 per share) and $13,000,000 to Garrison in exchange for 1,300,000 shares of Garrison Class A stock ($10 per share). JX 34; PX 97 at COLT 18547-51. The Class A stock was the same as the common stock, except it was entitled to a liquidated preference at $10 per share. JX 34; PX 97 at COLT 18547-51.

Garlock contributed to Garrison: the $375 million Stemco Note; all of the outstanding stock of Anchor; the rights to any future asbestos insurance recoveries; furniture, fixtures, and equipment; and all of the files, records, and data of the Asbestos Litigation Department. JX 33; PX 77. In exchange, Garrison issued 100,000 shares of Garrison common stock to Garlock and assumed defense and payment of Garlock's and Anchor's contingent asbestos liabilities. JX 41; PX 83, PX 97 at COLT 18443-77, 18553-54, PX 452; TR 263-64, 268-71, 708, 728. Garrison retained all twelve of the Asbestos Litigation Department personnel and entered into agreements to manage, defend, and administer any asbestos claims brought against Anchor or Coltec. JX 35, 38, 86; PX 97 at COLT 18483-518; TR 707-09. Under this agreement, Garrison also agreed to indemnify Garlock for uninsured asbestos liability, but Garrison did not indemnify Anchor. PX 88, 97; JX 36 at ¶ 1.6. Garrison, however, became Anchor's parent corporation. JX 36; PX 97 at COLT 18443-73. A separate Management Services Agreement was entered into between Garrison and Anchor, however, Garrison and Garlock also entered into reciprocal credit arrangements to invest Garrison's excess cash or to make interim loans to cover Garrison's cash needs. PX 84, 97 at COLT 18528-45; PX 425; JX 32, 39; TR 273-77, 1173-77, 1195-1208. In addition, Garrison established its own bank accounts so it could process and settle claims independently. TR 708-13, 1186-87. Leases for the Asbestos Litigation Department's facilities also were assigned from Coltec to Garrison. JX 37; TR 708.

On September 13, 1996, Garrison commenced operations with O'Reilly serving as President. TR 631, 707-09, 772. In November 1996, a Director of Finance was hired to establish a separate accounting department and all insurance reimbursement billing was brought in-house. TR 711-17, 1148-49, 1183-86, 1195-1208. Since that time, Garrison actively has managed all aspects of the asbestos litigation against Garlock and Anchor. TR 707-09, 772. O'Reilly's annual

bonus of $150,000-$200,000 was billed separately to insurance carriers. TR 664-65, 713. On September 13, 1996, Garrison had $15 million of cash on hand; thereafter, Garrison lost more than $80 million and, as of January 31, 2004, had a negative balance of $67.5 million. PX 425; TR 1209-10; A-TR 178-79; *see also* Eric Hellerman, "The Asbestos Litigation Crisis: Who Will Clean Up This Elephantine Mess?" *Washington Legal Foundation Working Paper Series* No. 114 (March 2003).

F. Garlock Initially Sold Garrison Stock Only To The Banks.

In October 1996, shortly after the establishment of Garrison, the Coltec Group began efforts to sell the 100,000 shares of Garrison common stock owned by Garlock to sophisticated investors or financial institutions to establish a market price. PX 99, 119, 129, 142; DX 210 at AA 20000; DX 322 at AA 15051; TR 254, 279-81, 405-06, 445. Coltec was concerned that if it first sold Garrison stock to service providers, the sale could be characterized as fee compensation. TR 405-06; *see also* 26 U.S.C. § 83(a).

Andolino personally contacted at least seven prospective sophisticated investors with an offer to sell Garlock's shares in Garrison for $1.1 million or $11 per share. PX 99, 119, 129, 142; JX 43; TR 281-82, 305-06. A term sheet explained that the purchase of Garrison stock was an extremely speculative investment, but that Coltec was willing to negotiate unspecified "appropriate exit strategies," since there was no public market for the shares. JX 43 at G15195.

In August 1996, Coltec moved its corporate headquarters to Charlotte, North Carolina, which also was the headquarters of NationsBank and First Union (hereinafter collectively "the Banks"). TR 1042, 1056-60, 1477-81; JX 30. In October 1996, Andolino contacted First Union about making an investment in Garrison. JX 74; TR 1479. First Union was

eager to develop a relationship with Coltec, but initially was not interested in purchasing Garrison stock as an investment. TR 1479, 1481, 1483. First Union reconsidered after Coltec agreed to pay for First Union's due diligence costs. DX 121; TR 1477-78, 1481-83. Late in the fall of 1996, First Union also joined a group of lenders that provided financing to Coltec and earned substantial income from that relationship. JX 70; PX 155; TR 1484-85.

In October 1996, Coltec's CFO also contacted NationsBank. TR 1051, 1480. NationsBank initially rejected the opportunity to invest in Garrison. TR 1052-56. Coltec's CFO contacted NationsBank again and asked NationsBank to reconsider, indicating that First Union was considering making a purchase of Garrison stock. JX 49; JX 51; TR 1052-57. NationsBank reconsidered, viewing this investment as a way to improve its business relationship with Coltec. JX 51; TR 1056-62. Several days later, NationsBank "[c]alled John Guffey and told him that we would proceed with the investment. [We] told him that we were doing this for relationship reasons, not just investment reasons, and expected to be 'at the table' as a player in their financing picture going forward." JX 51; *see also* TR 1052-61. NationsBank subsequently also earned substantial income through its relationship with Coltec. JX 54, 68, 71; TR 1049-51.

Thereafter, the Banks undertook due diligence jointly. JX 52, 58; PX 143; TR 307-09, 1485-88, 2575-76. KPMG Peat Marwick ("KPMG") and Stewart Economics, Inc. ("Stewart") were retained to analyze the Tillinghast Report and July 1996 Kahn Report. JX 42-63, 116-17; TR 513-23, 1485-86, 1545-46, 1575-77, 1602-03.

On December 3, 1996, Garlock provided a draft Confidential Offering Memorandum to the Banks that discussed the high risk nature of the investment, emphasizing the fact that best estimates of asbestos claims in the past had been underestimated. PX 136 at COLT 17129-50; JX 73 at C273,

C278-79, C289; TR 1077-78, 1526-29, 2577-78; *see also* JX 50 at BOA 0832; JX 67 at 2. An exit strategy was set forth in a separate Shareholders Agreement wherein the Banks were granted the right to "put" the Garrison shares to Coltec at fair market value[5] and Coltec had the right to "call" or buy back the shares at a fixed price; each option right was executable after five years.[6] JX 75 at §§ 3.1, 3.2(a), 3.3, 3.4; TR 286-91, 322-23, 1520-21, 2203-04.

Stewart issued an opinion on December 12, 1996 concluding that the Kahn Report was based on reasonable methods, but characterized Kahn's insurance recovery estimates as "best-case." JX 64 at BA 965. Therefore, the Banks established separate subsidiaries to insulate their banking business from any potential veil-piercing claims. TR 316, 319-20, 1067, 1501-02, 1517-18, 2586-87. NationsBank's subsidiary was GLM Investments, Inc.; First Union's subsidiary was 1005 Corp. JX 77-78; TR 319, 1067. On December 20, 1996, each of the Banks' subsidiaries separately entered into a Stock Purchase Agreement with Garlock, under which each purchased 50,000 shares of Garrison common stock for $250,000 or 100,000 shares for a total of $500,000 or $5 per share equaling a 6.67% minority block of stock. JX 66, 72-73, 75-76; PX 162, PX 163 at G 16515-27, PX 167; TR 318-20. In return, Coltec agreed to indemnify the Banks for any asbestos related claims that may arise in the future. JX 75 at § 5.5; TR 316-18, 1488-89, 1518, 2589-90. Coltec and the Banks also executed a contemporaneous Confidentiality

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[5] A "put" is "an option to sell at a specific price within a specified time limit." Herbert Filer, Understanding Put and Call Options 9 (9th ed.1972) ("Filer"). In this case, the put price depended on the financial condition of Garrison at the time and a formula employed to determine the fair market value of the stock. JX 73 at C273, C276-77; TR 287-88.

[6] A "call" option is "a contract, paid for when it is purchased, which gives the holder the right to buy, at his option, a specified number of shares of a stated stock at a fixed price, on or before a fixed date." Filer, at 57.

Agreement. JX 75 at § 4.1; TR 1519. And, the Banks required and obtained an opinion from counsel that both the Stemco Note and Garlock Note were enforceable. JX 60 at COLTEC 2248; JX 62 at COLTEC 5146; PX 134, 163 at G 16582-16587; TR 2597-98.[7]

As of this date, the Banks have not exercised their put rights and Coltec has not exercised its call options. TR 304-05, 1521, 1530, 2612-13. Both set of options have now expired.

G. In October 1998, 3% Of Garrison Stock Was Sold To Lead Regional Defense Counsel.

After the sale of Garrison stock to the Banks closed, Coltec directed its efforts to sell Garrison stock to a select group of lawyers involved in defending asbestos claims. PX 189; TR 724. Fifteen attorneys, ranked by annual billings, were invited to purchase stock at a June 5, 1997 meeting convened by O'Reilly and Andolino, at which time the formation of Garrison and opportunity to purchase Garrison stock was discussed. DX 222; JX 82-83, 88-90, 96; PX 412; TR 724-31, 820-21, 830-46, 1393-94. Afterwards, a meeting was convened at the offices of Kronish Lieb to discuss concerns raised by some of the defense counsel about the proposal and to begin working on the requisite paperwork. JX 92; PX 192-93; TR 733-34. Eventually, Coltec decided to reduce the exercise price on the call option to $15.25 per share. DX 1084 at 3, 18-22; DX 1000; DX 1010 at 5, 27-30.

In October 1998, Coltec sold 45,000 shares or 3% of its Garrison stock at $5 per share to lead attorneys in four regional defense firms. JX 99, 104; PX 225, 231-38; TR 731-

[7] KPMG's post closing January 21, 1997 Report also concluded that the Tillinghast Report was based on reasonable methods and took into account an upward surge in filings in 1995 and 1996, but warned that future trends were impossible to predict with certainty. PX 145 at BA 1049-50, 1053; PX 150 at BOA 814-15, 818.

34, 742-48, 832-33. The attorneys also were provided with a Stock Purchase Agreement, a Shareholders Agreement, and a Confidential Offering Memorandum similar to that used with the Banks. JX 95, 99, 100-03, 104, 105-07; PX 225, 230, 232, 234, 237-38; TR 742-48. The amount the attorneys might gain from the investment, however, was small in comparison to the legal fees they expected to earn during the period they held the shares. DX 1000 at GOV 231-33. Their put options opened in August 2003, but were never exercised. TR 771-72.

Although the parties spent a fair amount of time at trial on this transaction, the sale of Garrison stock to Coltec's lead regional defense counsel took place almost two years after the formation of Garrison. Therefore, the court considers this event to be irrelevant to the statutory issues concerning the formation of Garrison and sale of Garrison stock to the Banks. Accordingly, no further discussion of this event is necessary other than this background.

H. In January 1999, The Coltec Group Was Acquired By The B.F. Goodrich Corporation.

In January 1999, the Coltec Group was acquired by the B.F. Goodrich Corporation for approximately $2.5 billion. TR 136, 341, 632; A-TR 87-88. In 2002, Anchor, Garlock, Garrison, and Stemco were spun off into a new entity called EnPro Industries, Inc. TR 136, 632.

PROCEDURAL BACKGROUND

A. Administrative Proceedings At The Internal Revenue Service.

1. The Coltec Group's Consolidated Federal Income Tax Return For The Tax Year Ending December 31, 1996.

On September 15, 1997, the Coltec Group filed a consolidated federal income tax return for the tax year ending December 31, 1996. JX 85 at GX 24406-07; TX 1A at

¶¶ 1-2. On August 10, 2000, following an Internal Revenue Service ("IRS") examination of that return, the Coltec Group executed a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) in the amount of $82,708,152. PX 291; TX 1A at ¶¶ 3-5.

2. The Coltec Group's Deficiency And Assessment.

The IRS assessed the Coltec Group the full amount of the deficiency, $82,708,152, for the tax year ended December 31, 1996. The Coltec Group paid the full amount of the assessment through the following payments or refunds on the following dates:

(CREDITED or REFUNDED) DATE PAID	(CREDITED or REFUNDED) AMOUNT PAID
April 15, 1996	$ 3,853,065
April 15, 1996	$ 4,800,000
June 17, 1996	$ 9,000,000
December 16, 1996	$ 3,000,000
March 7, 1997	($15,000,000)
March 17, 1997	$ 64,531
April 15, 1997	($ 5,453,522)
August 10, 2000	$ 22,708,152
August 11, 2000	$ 60,000,000
August 21, 2000	($ 264,074)
Total:	$82,708,152

PX 177; TX 1A at ¶¶ 6-8.

3. The Coltec Group's Claim For A Federal Income Tax Refund.

On August 18, 2000, Coltec timely filed a federal income tax refund claim for $82,803,049 for the tax year ending December 31, 1996. PX 33, 177; TX 1A at ¶¶ 7-11. On January 31, 2001, however, the IRS disallowed the refund. JX 111; TX 1A at ¶¶ 12-13.

B. Proceedings In The United States Court Of Federal Claims.

On February 13, 2001, Coltec timely filed a complaint in the United States Court of Federal Claims for a federal income tax refund. TX 1A at ¶ 14. Initially, this case was assigned to the Honorable Lawrence M. Baskir, then serving as the Chief Judge of the United States Court of Federal Claims. The Government filed an answer on May 30, 2001. Fact and expert discovery commenced on August 5, 2002.

Count 1 of Coltec's complaint seeks a research tax credit of $8,103,324 against its 1993 federal income tax liability, resulting from alleged qualified research expenses incurred during the tax years 1992, 1993, and 1994, and carried forward and back to the 1993 tax year. Compl. ¶¶ 9-19. Coltec seeks a refund of $6,662,099 for the 1993 tax year for this credit. Compl. ¶ 8. Count 2 also seeks a $1,221,676 research tax credit and refund against Coltec's 1994 federal income tax returns. Compl. ¶¶ 20-25. On June 11, 2003, Judge Baskir granted Coltec's motion to bifurcate the research credit claims for 1993 and 1994 and stayed the proceedings on those claims to allow the refund associated with the Garrison transaction to proceed to trial. On August 15, 2003, this case was reassigned to the undersigned judge.

On January 30, 2004, discovery concluded. On March 3, 2004, Coltec filed a Pre-Trial Brief. On April 2, 2004, the Government filed a Pre-Trial Memorandum of Contentions of Fact and Law ("Gov't Pre-Trial Memorandum").

A trial was held in Washington, D.C., on May 3-7, 10-14, and 17-18, 2[illegible], during which the court heard testimony from twenty-[illegible] witnesses.[8] During trial, the Government

[8] Coltec's three fact witnesses were: John W. Guffey, Jr., former Coltec President and CEO; Joseph Andolino, former Coltec Vice President of Taxation; and Timothy O'Reilly, former President of Garrison. Coltec's expert witnesses were: Michael Angelina, co-author of the Tillinghast Report; and Joseph Kahn, author of the Kahn Report. On rebuttal, Coltec proffered the following expert witnesses: Linda Barber, Partner at Navigant Consulting; Dr. Kenneth R. Cone, Senior Vice President of Lexecon, Inc.; Stephen Sherman, Co-National Leader of Valuation Services for KPMG, LLP; and Dr. Seymour Jones, Clinical Professor of Accounting, Stern School of Business, New York University. In addition, Robert W. Long, former Assistant General Counsel at NationsBank, testified as a fact witness during Coltec's rebuttal case.

The Government's fact witnesses included: Chris Sauvigne, former Arthur Andersen partner; Michael D. Gisby, an Arthur Andersen senior associate assigned to the Coltec account in 1996; Gregory W. Powell, former NationsBank Senior Vice President; Thomas W. McClay, Arthur Andersen senior associate assigned to the Coltec Group account in 1996; Thomas B. Jones, former Coltec Group Assistant Treasurer; Andrew Giller, former Vice President of Finance for Garrison Litigation Management Group; Jeffrey Hicks, former Coltec Group in-house tax attorney; Paul Capiello, former Coltec Group Director of Tax Analysis; Robert J. Tubbs, former Coltec Group General Counsel; William F. Mahoney, shareholder in the law firm of Segal, McCambridge, Singer, and Mahoney; David L. Wedding, former Arthur Andersen partner; David Trotter, former First Union Relationship Manager; Daniel Lee Rourke, former KPMG employee who analyzed the Tillinghast Report for the Banks; Frederic Goldfein, law partner in the firm of Goldfein and Joseph and former Northeast Regional Counsel for Garrison.

In addition, the Government proffered the following expert witnesses: Gayle Koch, Director, Head of Environmental/Mass Tort Practice, The Brattle Group; Dr. A. Lawrence Kolbe, Principal and Director of the Brattle Group; Dr. Raymond Ball, Sidney Davidson Professor of Accounting, Graduate School of Business, University of Chicago; Dr. Robert McDonald, Erwin P. Nemmers Distinguished Professor of Finance at the Kellogg Graduate School of Management, Northwestern University; and Rees Morrison, shareholder in the legal consulting firm of Hildebrandt International. Ms. Koch and Dr. Kolbe also were recalled during the Government's surrebuttal.

asked the court to reconsider a May 14, 2003 Privilege Order issued by Judge Baskir ("Privilege Order"), which allowed thirty-nine documents containing "risk assessment and legal analysis of the proposed transaction to be redacted." In light of extensive evidence proffered at trial regarding Coltec's concerns about "veil piercing" and the extent of contingent asbestos liabilities faced by Garlock and Anchor, the court decided to require Coltec to produce documents containing "risk assessment" information and Coltec complied. DX 214. The court indicated that it would not revisit Judge Baskir's well reasoned decision on privilege grounds, but would allow the Government the opportunity to brief this issue further after trial, even though the Government did not file a motion for reconsideration at the time the Privilege Order was entered. Having reconsidered the Government's position, the court denies the Government's request to have the thirty-nine documents at issue produced and concurs with Judge Baskir's prior ruling that those documents are subject to the attorney work-product privilege.

On August 6, 2004, the parties filed redacted trial exhibits. On August 13, 2004, Coltec filed Post-Trial Proposed Findings of Fact and Conclusions of Law. On August 16, 2004, the Government filed Post-Trial Proposed Findings of Fact and Conclusions of Law. On August 30, 2004, Coltec filed a Post-Trial Brief ("Coltec Post-Trial Brief"), and the Government filed a Post-Trial Memorandum ("Gov't Post-Trial Memorandum").

On September 29, 2004, the court entertained a five and one-half hour oral argument by the parties to address issues arising from post trial briefs and respond to issues raised by the court. On October 4, 2004, at the request of the court, the parties submitted a flow chart depicting their legal argument, together with additional research. The court also allowed further submissions by counsel on October 6, 2004 and October 12, 2004.

DISCUSSION

A. Jurisdiction.

The United States Court of Federal Claims has "jurisdiction to render judgment upon any claim against the United States founded upon . . . any act of Congress or any regulation of an executive department[.]" 28 U.S.C. § 1491. *See New York Life Ins. Co. v. United States*, 118 F.3d 1553, 1558 (Fed.Cir.1997) (reaffirming the jurisdiction of the United States Court of Claims over a suit concerning a federal tax refund). Coltec also has met all other jurisdictional requirements.

Pursuant to 26 U.S.C. § 7422(a) no claim for a refund may be filed for the recovery of any internal revenue tax until a claim has been filed with the IRS. Coltec filed its claim for a refund of $82,803,049 on August 18, 2000. PX 33; TX 1A at ¶¶ 10-16. In addition, on December 31, 1996, Coltec paid the tax amount in dispute, as required by 26 U.S.C. § 6511(a). TX 1A at ¶ 6. On February 13, 2001, Coltec filed a complaint in the United States Court of Federal Claims, within two years from the date the IRS notified Coltec of the disallowance and well within the six year statute of limitations, set forth in 28 U.S.C. § 2501. TX 1A at ¶ 14.

B. Standard Of Review.

In a tax refund suit the taxpayer has the burden of proof. *See Niles Bement Pond Co. v. United States,* 281 U.S. 357, 361, 50 S.Ct. 251 (1930). Where liabilities are assumed, "the burden is on the taxpayer to prove such assumption . . . is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence." 26 U.S.C. § 357(b)(2); *see also* Treas. Regs. § 1.357-1(c) (equating "clear preponderance" with "unmistakable" proof).

C. Relevant Statutory Provisions.[9]

1. The Requirements Of An Exchange Pursuant To 26 U.S.C. § 351.

Congress has determined that a controlled corporation's issuance of property for stock does not occasion immediate recognition of gain or loss. *Compare* 26 U.S.C. § 1001(a) ("Section 1001(a)")[10] *with* 26 U.S.C. § 351(a) ("Section 351(a)").[11] And, Congress has "permitted deferment of such tax liability through the provisions of [Section 351(a)] . . . in cases in which the taxpayer transfers property to a corporation solely in exchange for stock if, immediately following the transaction, [the taxpayer] controls the transferre[d] corporation." *Campbell v. Wheeler*, 342 F.2d 837, 838 (5th Cir.1965); *see also* Bittker & Eustice ¶ 3.01 (quoting *Portland Oil Co. v. Commissioner*, 109 F.2d 479, 488 (1st Cir.

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[9] The court found both parties' exposition of the relationship between relevant statutory provisions of the Internal Revenue Code ("Code") to be less than satisfactory. Therefore, the court frequently consulted, liberally has paraphrased, and deeply is indebted to the instruction and scholarship of: Martin D. Ginsburg and Jack S. Levin, Mergers, Acquisitions, and Buyouts: A Transactional Analysis of the Governing Tax, Legal, and Accounting Considerations (Dec.2003) ("Ginsburg & Levin") and Boris I. Bittker and James S. Eustice, Federal Income Taxation of Corporations and Shareholders (7th ed.2002) ("Bittker & Eustice").

[10] Section 1001(a) provides:

> Computation of gain or loss.—The gain from the sale or other dis position of property shall be the excess of the amount [of gain] realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

26 U.S.C. § 1001(a).

[11] Section 351(a) provides that "the transferor shall recognize no gain or loss if property is transferred to a corporation solely in exchange for its stock; and if the transferor or transferors control the corporation immediately after the exchange." 26 U.S.C. § 351(a).

1940), *cert. denied,* 310 U.S. 650, 60 S.Ct. 1100, 84 L.Ed. 1416 (1940)) ("[Section 351 delays a taxpayer's recognition of] gain or loss [that] may have accrued in a constitutional sense, but where in . . . economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out on a venture[.]"). Even if the transferor pre-planned a prompt disposition of the transferor's stock, as happened in this case, Section 351(a) is still applicable if the immediate "control" requirement is satisfied. *See* Ginsburg & Levin ¶ 901.

2. The Treatment Of Assumed Liabilities In A 26 U.S.C. § 351 Exchange.

Congress also has determined that the tax deferred benefits of Section 351 are preserved, even where a transferee assumes a transferor's liabilities. *See* 26 U.S.C. § 357(a).[12] The general rule found in Section 357(a) provides that "the transferee corporation's assumption of liabilities is not treated as money or other property. The transferor's gain is recognized only if money or other property is exchanged." 26 U.S.C. § 357(a). Specifically, Section 357(a) applies to "liabilities" in existence before the time when the Section 351 exchange occurred, such as "mortgages, trade obligations, bank loans, customers' deposits, and the like arising from the ordinary course of business; and this should be true even though the transferor, at the time of the § 351 exchange, is

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[12] Section 357(a) provides that if:

> (1) the taxpayer receives property which would be permitted to be received under Section 351 . . . without the recognition of gain if it were the sole consideration, and (2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability, then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351[.]

26 U.S.C. § 357(a).

able to pay such obligations himself but chooses instead to have the transferee corporation assume, or take property subject to, the obligations." Bittker & Eustice § 3.06[3].

The assumption of liabilities, however, may trigger Section 358(d)(1)[13] requiring any assumption of liabilities to be treated as money, but there are two important exceptions: 26 U.S.C. § 357(b) ("Section 357(b)") and 26 U.S.C. § 357(c)(1) ("Section 357(c)(1)").

a. The Effect Of 26 U.S.C. § 357(b).

Section 358(d)(1) does not apply where "taking into consideration the *nature of the liability* and the circumstances in the light of which the arrangement for the assumption . . . was made, it appears that the *principal purpose of the taxpayer* . . . was a purpose to avoid Federal income tax on the exchange, or . . . if not such purpose, was not a *bona fide* business purpose." 26 U.S.C. § 357(b) (emphasis added).[14] If the

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[13] Section 358(d)(1), provides:

> Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer . . . , such assumption . . . shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

26 U.S.C. § 358(d)(1).

[14] Section 357(b) provides:

> (1) In general.—If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption . . . was made, it appears that the principal purpose of the taxpayer with respect to the assumption . . . described in subsection (a)—
>
> > (A) was a purpose to avoid Federal income tax on the exchange, or
> >
> > (B) if not such purpose, was not a bona fide business purpose, then such assumption . . . (in the total amount of the liability assumed . . . pursuant to such exchange) shall, for purposes of section 351 or 361 (as the case may be), be considered as money received by the taxpayer on the exchange.

taxpayer cannot satisfy the requirements of Section 357(b) by a "clear preponderance of the evidence," then the assumption of liabilities will be treated as money or "boot," and the taxpayer is required to recognize any gain up to the full amount of the liability. *See* 26 U.S.C. § 357(b)(1).

b. The Effect Of 26 U.S.C. § 357(c)(1).

Section 358(d)(1) also will not apply and any gain will be recognized "if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange[.]" 26 U.S.C. § 357(c)(1).[15] Where the amount of liabilities transferred is greater than the basis of transferred property, then the transferor recognizes gain on the amount by which the liability exceeds the basis of the transferred property. *Id.*

Section 357(c)(3)(A)(i),[16] however, excludes liabilities from consideration under Section 357(c)(1), *i.e.*, if payment would give rise to a deduction under 26 U.S.C. § 162(a) ("Section 162(a)").[17] If a liability is excluded under Section 357(c)(3)(A)(i), it also is excluded from 26 U.S.C. § 358(d)(1).

> (2) Burden of proof.—If any suit or proceeding where the burden is on the taxpayer to prove such assumption . . . is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

26 U.S.C. § 357(b).

[15] Section 357(c)(1) provides:

> if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

26 U.S.C. § 357(c)(1).

[16] Section 357(c)(3)(A)(i) provides:

3. 26 U.S.C. Section 358(a)(1) Determines Basis In A Section 351 Exchange.

As a general matter, an asset's basis is equal to its cost. *See* 26 U.S.C. § 1012 ("Section 1012").[18] Congress has determined that ~~the~~ transferor's basis in stock received from a Section 351 exchange is the same as the transferor's basis in the property conveyed in exchange for the transferee's stock. *See* 26 U.S.C. § 358(a)(1).[19] If a transferor receives money

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> If a taxpayer transfers, in an exchange to which Section 351 applies, a liability the payment of which either—
>
> > (i) would give rise to a deduction, . . . then, for purposes of paragraph (1), the amount of such liability shall be excluded in determining the amount of liabilities assumed or to which the property transferred is subject.

26 U.S.C. § 357(c)(3)(A)(i).

[17] Section 162(a) provides:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business[.]

26 U.S.C. § 162(a).

[18] Section 1012 provides: "The basis of property shall be the cost of such property[.]" 26 U.S.C. § 1012.

[19] Section 358(a)(1) provides:

> in the case of an exchange to which Section 351 applies: The basis of the property permitted to be received under [Section 351] without the recognition of gain or loss shall be the same as that of the property exchanged—
>
> > (A) decreased by—
> >
> > > (i) the fair market value of any other property (except money) received by the taxpayer,
> >
> > > (ii) the amount of any money received by the taxpayer, and
> >
> > > (iii) the amount of loss to the taxpayer which was recognized on such exchange, and
> >
> > (B) increased by—
> >
> > > (i) the amount which was treated as a dividend, and

or "boot" during a Section 351 exchange, however, the basis in stock received by the transferor is the same as the basis of the property exchanged, minus the fair market value of the boot received plus gain recognized by the transferor. *See* 26 U.S.C. § 358(a)(1).

D. The Coltec Group's Argument.

Coltec made three core arguments that are summarized here. *See* Coltec Post-Trial Brief at 2-35. The court requested that Coltec reduce its statutory argument into a "flow chart," which is attached hereto as Appendix A.

1. Federal Tax Law Does Not Require That Garlock's Basis In Garrison Stock Be Reduced By The Contingent Asbestos Liabilities That Garrison Assumed.

Coltec claims that Garlock's contribution of Anchor's stock and the Stemco promissory note to Garrison was qualified property under Section 351 and therefore Garlock recognized no gain or loss on the exchange. Coltec's Post-Trial Brief at 2. Garlock's basis in the Garrison stock received therefore is asserted to be the same as Garlock's basis in the Anchor stock and the Stemco promissory note, pursuant to Section 358(a)(1) and (d)(2), about which the court is advised "[t]here is no dispute." *Id.*

Next, Coltec asserts that no reduction in Garlock's basis is required because of Garrison's assumption of Garlock's contingent asbestos liabilities, since they are not "liabilities" under either Section 357 or Section 358(d). *Id.* at 3. This is so because those liabilities would have been deductible by Garlock, if they were paid prior to the Section 351 exchange

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(ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

26 U.S.C. § 358(a)(1).

and, therefore, pursuant to Section 358(d)(2), do not reduce Garlock's basis in Garrison stock. *Id.* at 3-5.

In the alternative, Coltec argues that even if Garlock's contingent asbestos liabilities were liabilities under Section 358(d), that section of the Code does not require the reduction of Garlock's basis in Garrison stock by the amount of the asbestos liabilities. Thus, Coltec insists the only effect Section 357(b) can have is to increase Garlock's basis, if the principal purpose for the assumption of liabilities was to avoid the tax on the exchange or the assumption had no *bona fide* business purpose. *Id.* at 6-7. Thus, Coltec points out that Section 358(d)(2) and Section 357(c)(3)(A) specifically exempt Garlock's asbestos liabilities from the reach of Section 358(a)(1). *Id.* at 9-12. Thus, since Section 357(c)(3)(A) refers to liabilities that would have been deductible if paid by Garlock prior to the Section 351 exchange, the obligation to pay for those liabilities after the exchange was assumed by Garrison. *Id.* at 11. Therefore, Coltec urges the court to reject the Government's interpretation of Section 358(d)(2) to require liabilities to be deducted and reduce the basis in stock because Section 358(d)(2) speaks of liabilities that would be deductible by the transferor, but only if they were paid prior to the transfer. *Id.* at 11-12.

On this issue, Coltec concludes that Garlock's basis in the Garrison stock must be calculated under Section 358(a) to include Garlock's basis in the Stemco promissory note and in Anchor's stock. *Id.* at 13. Although the Government claims that Garlock's basis in the Garrison stock was inflated, Coltec counters that, even if that were true, the Government's argument is irrelevant. *Id.* at 13-14.

2. Garlock's Transfer Of Garrison Stock To The Banks Was A Sale.

Next, Coltec argues that Garlock's sale of Garrison stock to the Banks should be respected if "the legal form chosen

would affect the economic interests of the parties." *Id.* at 15. At trial, the Government proffered expert testimony that characterized Coltec's transaction with the Banks as a "constructive non-sale." Coltec dismisses that theory because of the reality that the Banks continue to own Garrison stock and the put and call options were never exercised and are now expired. *Id.* at 17-18. Moreover, Coltec countered "tax law does not recognize the concept of a 'constructive non-sale.'" *Id.* at 19. As for the Government's argument that the Banks acquired a "hybrid security," Coltec argues, even if true, that fact is irrelevant for purposes of how the tax law treats the transaction with the Banks. *Id.* at 20.

3. No Judicial Doctrine Disallows Garlock's Loss On The Sale Of Garrison Stock To The Banks.

Coltec claims that the sale of Garrison stock to the Banks did not require a separate non-tax business purpose for the loss to be deductible and that the tax loss claimed by Garlock resulted from a real economic loss suffered in its "historic business." *Id.* at 23-24. The fact that the Banks were viewed as "friendly" buyers that purchased the Garrison stock to improve their relationship with Coltec is irrelevant with regard to the tax consequences to Garlock. *Id.* at 24-25.

Thus, Coltec concludes that the "Garrison transactions were not a sham. They had non-tax business purposes and advantages. And they had economic substance . . . because they permanently changed the parties' economic positions, legal relations, and non-tax business interests, and created genuine, enforceable obligations to the third-party Banks." Coltec Post-Trial Brief at 25-26; *see also id.* at 32. The key distinction between the "sham" cases, cited by the Government, is that the Garrison transaction was not transitory and had a legitimate business purpose, *i.e.*, to isolate and further insulate the asbestos litigation activities from Coltec's core business and to streamline and better manage asbestos litigation activities and facilitate settlements. *Id.* at 29-30.

E. The Government's Counter-Arguments.

The Government's counter-arguments also are set forth here in summary form. *See* Gov't Post-Trial Memorandum at 6-40. The court also requested that the Government reduce its statutory argument into a "flow chart," which is attached hereto as Appendix B, together with the Government's depiction of the relevance of the "economic substance" doctrine.

1. Garrison's Assumption Of Garlock's Asbestos Liabilities Reduces Garlock's Basis In Garrison Stock.

First, the Government argues that Garrison's assumption of asbestos liabilities reduced Garlock's basis in Garrison stock under Section 358(d)(1). Gov't Post-Trial Memorandum at 9-12; *see also id.* at 12-14; A-TR 67. If the asbestos liabilities at issue are not liabilities under the Code, *ipso facto*, the Government concludes that they must be "other property," and therefore Garlock's basis in the Garrison stock would have to be reduced by its "fair market value" under Section 358(a)(1)(A)(i). Gov't Post-Trial Memorandum at 13. The Government, however, concedes that since the asbestos liabilities in this case are "(as their name implies) 'liabilities' . . . the Court will need to address Coltec's other attempts at evading the general rule that liability assumptions reduce basis, just like any other money or other property received." *Id.* at 14.

Therefore, the Government contends that Coltec failed to satisfy the requirements of Section 357(c)(3) and may not invoke Section 358(d)(2). *Id.* at 15. Coltec's failure to qualify for a Section 357(c)(3) exemption is premised on the Government's position that "'the principal purpose' with respect to Garrison's assumption of the asbestos liabilities was not a *bona fide* non-tax business purpose." *Id.* at 16; *see also id.* at 16-23. In addition, the Government argues that Coltec failed to demonstrate that the asbestos liabilities "would give rise to a deduction" within the meaning of Sec-

tion 357(c)(3)(A)(i), and therefore Coltec is not entitled to Section 358(d)(2) relief. *Id.* at 23-34. For these reasons, Garlock's basis in the Garrison stock should be reduced by $371.2 million, the amount of Garlock liabilities assumed by Garrison.

2. The Coltec Group Failed To Prove That Garlock's Transfer Of Garrison Stock To The Banks Was A Sale.

Coltec claims that it recognized a loss of approximately $370 million from the sale of Garrison stock to the Banks under Section 1001(a). *Id.* at 34-35. The Government, however, contends that the "key to determining whether a particular transaction is properly characterized as a sale is [the] determination of whether the benefits and burden of ownership have passed from the seller to the buyer." Gov't Post-Trial Memorandum at 35. Since the put and call options included in the Shareholders Agreement "had the effect of negating any transfer of beneficial ownership of the Garrison shares, [therefore,] no sale . . . occurred." *Id.* at 37; A-TR 69.

3. The Coltec Group Failed To Prove That The Transactions Had Economic Substance.

Finally, even if Coltec met all the requirements of the Code, the Government urges the court to apply the "economic substance" doctrine in this case to invalidate the benefits the taxpayer achieved. Gov't Post-Trial Memorandum at 37; A-TR 69, 76. The doctrine has two components: "(1) a subjective inquiry into whether the transaction was carried out for a valid business purpose; and (2) an objective inquiry into the objective economic effect of the transaction." Gov't Post-Trial Memorandum at 38. Coltec is claimed to have failed the subjective part of the economic substance doctrine because the "[t]ransactions were the product of a tax avoidance strategy conceived by [Arthur] Andersen and Coltec's tax department to shelter the capital gain from the sale of Holley [Automotive]." *Id.* at 38. In addition, the Government con-

cludes that the transfer of Garrison stock to the Banks failed the objective inquiry and "was illusory because Coltec had transferred only bare legal title—not the incidents of ownership." *Id.* at 39.

F. The Court's Resolution Of Issues Concerning Statutory Interpretation.

1. The Formation Of Garrison Satisfied Each Of The Requirements Of Section 351.

a. Coltec And Garlock Transferred Qualifying "Property" To Garrison.

The United States Supreme Court has instructed the lower courts that property is determined by "existing rules or understandings that stem from an independent source such as state law." *Board of Regents of State Colleges v. Roth,* 408 U.S. 564, 577, 92 S.Ct. 2701, 33 L.Ed.2d 548 (1972). On September 13, 1996, Coltec transferred $14 million in cash to Garrison. In addition, Garlock transferred to Garrison: 100% of Anchor stock, with a basis of $4,206,091; any potential future payments from Anchor's insurance coverage; and a $375 million promissory note issued by Stemco to Garlock. Anchor's stock, any potential payments from Anchor's insurance coverage, and Coltec's $13,998,000 cash contribution, are all traditional recognized forms of property.[20]

The Stemco promissory note provides "for all purposes [it] shall be governed by and construed in accordance with the laws of [New York]." JX 27 at G 14819. New York state

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[20] Property is not defined in the Internal Revenue Code, but stock, cash, and certain debt instruments have been treated as qualifying for tax-free treatment. *See, e.g., Peracchi v. Commissioner*, 143 F.3d 487, 489 (9th Cir.1998) ("Corporations may be funded with any kind of asset, such as equipment, real estate, intellectual property, contracts, leaseholds, securities or letters of credit."); *E.I. Du Pont de Nemours & Co. v. United States*, 200 Ct.Cl. 391, 471 F.2d 1211, 1218 (1973) ("[C]ourts have advocated a generous definition of 'property.'").

courts recognize a promissory note as property. *See, e.g., Lippes v. Atlantic Bank of New York*, 69 A.D.2d 127, 419 N.Y.S.2d 505, 512 (N.Y.App.Div.1979) (citing *Reiter v. Sonotone Corp.*, 442 U.S. 330, 99 S.Ct. 2326, 60 L.Ed.2d 931 (1979) ("the word 'property' has a naturally broad and inclusive meaning. In its dictionary definitions and in common usage 'property' comprehends anything of material value or possessed [.]")); *In re Tiffany's Estate*, 143 A.D. 327, 128 N.Y.S. 106, 107 (N.Y.App.Div.1911) ("[T]he Legislature of this State . . . considered promissory notes property[.]"). Therefore, the court has determined the Stemco Note must be considered property in this case and the first requirement of Section 351 was met. *See* 26 U.S.C. § 351(a). As discussed herein, since the Stemco promissory note is property, it is entitled to be assigned a basis, which would not be allowed if it were a liability.

b. Coltec And Garlock Received Only Stock From Garrison.

Coltec received 93% of the equity of Garrison; Garlock received 7% of the equity of Garrison. Therefore, the second requirement of Section 351 was met. *See* 26 U.S.C. § 351(a).

c. Immediately After The Exchange, Coltec And Garlock Had 100% Control Over Garrison.

Section 351 applies only if the property contributed is owned by the same persons both before and after the exchange. As the Honorable Alex Kozinski, a former Chief Judge of the United States Court of Federal Claims, now sitting on the United States Court of Appeals for the Ninth Circuit, has observed:

> Continuity of investment is the cornerstone of nonrecognition under [S]ection 351. Nonrecognition assumes that a capital contribution amounts to nothing more than a nominal change in the form of ownership; in substance the shareholder's investment in the property continues.

Peracchi, 143 F.3d at 490; *see also* Bittker & Eustice ¶ 3.03[2], at 3-17 ([Section 351(a)] is "designed to ensure that the transferor will retain a continuing equity interest in the transferor corporation so as to justify nonrecognition of the gain or loss that is realized upon the exchange.").

In this case, immediately after the exchange, Coltec and Garlock owned and controlled 100% of the total combined voting power of all classes of Garrison stock entitled to vote. Therefore, the third requirement of Section 351 was met. *See* 26 U.S.C. § 351(a).

2. Garrison's Assumption Of Garlock's Contingent Liabilities Did Not Reduce Garlock's Basis In Garrison Stock.

a. The Effect Of Section 358(d)(1).

The assumption of liabilities typically is treated as money received. *See* Section 358(d)(1). Although the Code does not define "liability," Treas. Reg. § 1.461-1(a)(2)(i) provides that, for an accrual method taxpayer, a liability "is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability [and] the amount of the liability can be determined with reasonable accuracy." *See also* 26 U.S.C. § 461(a); *Brown v. Helvering*, 291 U.S. 193, 200, 54 S.Ct. 356, 78 L.Ed. 725 (1934) ("Except as otherwise specifically provided by statute, a liability does not accrue as long as it remains contingent."); Black's law dictionary 925 (7th ed.1999) (emphasis in original) ("1. The quality or state of being legally obligated or accountable . . .—Also termed *legal liability*. 2. (*often pl.*) A financial or pecuniary obligation; DEBT <tax liability>[.]").

In this case, the estimated $371.2 million of Garlock asbestos liabilities assumed by Garrison were contingent, since both of the events necessary to establish the fact of the liability had not occurred, *i.e.*, the filing of a lawsuit asserting a

claim and an adjudication of liability. *See Crane v. Commissioner*, 331 U.S. 1, 7, 11, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947) ("[W]ords of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses. [Therefore,] we can conclude that the proper basis . . . is the value of the property, undiminished by mortgages[.]"). From a tax perspective, Coltec will reduce its basis in the Garrison stock if and when the liabilities accrue and are satisfied by Garrison. *See Jewell v. United States*, 330 F.2d 761 (9th Cir.1964) ("Congress was willing to leave the tax consequences of the exchange here involved to come out in the ultimate wash, the disposition by [Garrison] of [its] stock. The fact that [Garlock] was paid nothing for [Garrison's assumption of liabilities] will mean that it has no basis [since liabilities have no basis], . . . but [Garlock] will be taxed accordingly upon what it gets for [the stock at the time it is sold]."). *Id.* at 767; *see also* A-TR 180-81. Therefore, as a matter of law, Garlock was not required to reduce the basis of its stock, under Section 358(d)(1), by the liabilities assumed by Garrison.

In fact, Congress became aware that Section 358(d)(1) did not require a transferor in a Section 351 exchange to reduce basis in stock received by the amount of any contingent liabilities assumed by the transferee and so it changed the law, enacting 26 U.S.C. § 358(h), effective October 18, 1999, "to include any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of the title." 26 U.S.C. § 358(h)(3); *see also* H.R. Conf. Rep. No. 106-1033 at 1019 (2000). The Garrison transaction, however, took place in 1996. For this additional reason, the court has determined, as a matter of law, that Section 358(d)(1) is not applicable in this case.

b. The Effect Of Section 357(b)(1)'s "Tax Avoidance" And "Business Purpose" Tests.

Assuming *arguendo* that the Garlock contingent asbestos liabilities assumed by Garrison were included within the scope of Section 358(d)(1), as the Government argues, thus requiring the assumption of liabilities to be treated as money, such liabilities, nevertheless, are excluded from recognition by operation of Section 358(d)(2) and Section 357(c)(3)(A)(i), unless Section 357(b)(1) applies. Turning first to Section 357(b), here Coltec must establish thereunder that Garrison's assumption of the Garlock liabilities was not undertaken for "the principal purpose . . . to avoid federal income tax [.]" 26 U.S.C. § 357(b)(1)(A); *see also* A-TR 20, 79-81. In addition, Coltec must demonstrate that assumption of such liabilities also had a "bona fide business purpose." 26 U.S.C. § 357(b)(1)(B). Both of these "tests" must be established by a "clear preponderance of the evidence." 26 U.S.C. § 357(c).

i. The "Tax Avoidance" Test.

The existence of tax avoidance motives does not preclude a transaction from meeting the requirements of Section 357(b)(1), as the oft-quoted dictum of *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935), makes clear:

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.

Id. at 469, 55 S.Ct. 266; *see also Frank Lyon Co. v. United States*, 435 U.S. 561, 580, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1977) ("We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction.").

In this case, Coltec's CEO, John Guffey, clearly was aware of the potential tax savings that may result from the formation

of Garrison, but he testified that the tax benefit was not "the principal reason" for his approval of the transaction:

> Q. [Coltec's Counsel:] And were you in 1996 . . . aware of the tax benefits that would flow from the restructuring that was proposed?
> A. [Mr. Guffey:] You know . . . I'm sure I would have been—that would have been attractive, that if there was a tax benefit, that's a plus . . . I can tell you this, that it would not have been overweighing, overpowering motivation for [me]. Again, even though tax sometimes can be significant, it is something I can define, you can afford it, what it did for us on the asbestos side would have been my passion . . . it really was just a continuation of the work in process we had. We were working continuously to control as best we could this monkey that was right around the corner all the time on our back: asbestos.

TR 86-87; *see also* JX 115 at G15209-11; A-TR 121-24, 151-52. The court found Mr. Guffey's testimony to be candid and credible. A-TR 219.

Guffey had every reason to be concerned about veil piercing claims against Garlock and Coltec in light of Anchor's diminishing insurance coverage. By June 1995, three of Garlock's insurers—Mission, Transit, and Integrity—were insolvent. TR 673. As O'Reilly testified:

> At that time it was questionable on the Equitos side of the London coverage because, again, that was a fairly recently new established run-off company from Lloyds. We knew North River had some solvency issues, and was at that time part of Xerox, but Xerox was trying to unload it and nobody was taking it. And Home had some issues that were just starting to bubble at that time. They eventually did go into insolvency[.]

TR 673.

By 1996, despite O'Reilly's best efforts to stretch out Anchor's insurance coverage for asbestos claims, it was nearly exhausted. TR 74-78, 109-11, 672-77, 797-98. To make matters worse, asbestos claims were increasing, as an independent review prepared by Peat Marwick LLP confirmed:

> The most important observation about the [asbestos] filings is that there have been large increases in recent years:
>
> - From about 12,000 claims in 1993 to 41,000 in 1994 for the UNR Trust;
> - From 15,000 claims in 1993 to about 26,000 claims in 1994 to nearly 46,000 claims in 1995 for the Manville Trust;
> - From about 28,000 claims in 1994 to 46,000 claims in 1995 for [Owens-Corning Fiberglass];
> - From 26,000 claims in 1994 to 48,000 claims in 1995 to over 50,000 claims in 1996 (estimated) for Garlock.
>
> The recent surge in filings has impacted all defendants and all trusts receiving claims.

PX 150 at BOA 814. Peat Marwick's Report further concluded that "the estimates of liability arising from present and future claims against Garlock and Anchor . . . are based on reasonable and appropriate theory and methods given the data available at the time these estimates were prepared. . . . It is our opinion [, however,] that the actual liability estimate is more likely to [be] higher than . . . it is to be lower." PX 150 at BOA 818-19; *see also* PX 145 at BA 1052-53; TR 1599-1600.

On December 4, 1995, Coltec met with Kaye Scholer, the law firm that represented Johns-Manville, to discuss the option of placing Anchor, and perhaps Garlock, into bankruptcy—at the same time the proposed Garrison transaction

was being considered. TR 681-84; *see also* TR 77. Although Coltec ultimately decided not to pursue bankruptcy and try to continue to defend asbestos claims against Anchor, Coltec "had an overriding fear that when the insurance assets had been depleted, that we would be facing challenges from the plaintiff bar to pierce the corporate veil, establish successor liability or any type of fraud action, any type of action whatsoever that could get beyond Anchor into the Garlock assets and/or the Coltec assets and that was an overriding daily concern that we in the litigation side of things faced." TR 676-77. Therefore, during 1996, Kaye Scholer continued to work with Tillinghast to obtain a better grasp of the financial impact of the asbestos situation and advise the Coltec Group about bankruptcy options until the company was sold. TR 682.

The isolation of Garlock's contingent liability exposure from Coltec's core business also was an important factor in the company's ability to attract a suitor that might be willing to acquire the entire Coltec Group.

> Q. [Coltec's Counsel:] Well then what if any did a separate corporation like Garrison to manage the asbestos liabilities have on your ability either to be acquired, Coltec be acquired or for Coltec to do the acquiring?
> A. [Mr. Guffey:] Oh, I think that's—that was, that would have been a real—that was a real plus to us. Garrison also, I should have mentioned before, when we were thinking about Garrison, another part of my job was I spent a lot of time on Wall Street. When I say Wall Street, in the financial community, I spent a lot of my time giving presentations at seminars put on by Morgan Stanley, Shearson, Gabelli, et cetera. They would have these throughout the year. And you go in and tell your story. I also—we were largely institutionally held from the shareholder standpoint, so it was very usual for me to meet with Neuberger Berman, J.P. Morgan on the investment side and these various—T. Rowe Price here in

Baltimore, to[o]—they were major shareholders. And they put you under quit [sic] a grilling about your company. And one question that would always come up was asbestos. And not to drag this out but I will use the word fence. I could define a tax cost, if you want to know what a tax rate is, I can define that and tell how many dollars it is. If they want to know how much capital you are going to spend in the year 1996, I could tell them what our budget was and could come pretty damn close, we are going to spend 80 million on capital. When it came to asbestos, there was no definition. And that was true of everybody that was in this problem. You couldn't put a fence around it. So one of the things that a separate corporation did, at least we had a business plan within the separate corporation, I visualized we could have this business plan, we would have a definition in it for that time frame, at least, where we could talk to the investment community about what we were doing with asbestos, how we were managing it, how we looked at quantifying it, what it meant to us in their time frame. That same vehicle would help us in any merger talks. There is a process called due diligence. If you are open to a merger talk and each side has due diligence teams, the better you can define every area of their questioning, of whether they are buying a good asset or not, is to your benefit and their benefit. So having it separate—and it worked out that way for us in discussions we had on mergers, *having a separate entity defining the management of it and having experts within that entity to define what they were doing about the management of it, I think proved to be a plus.*

TR 81-83 (emphasis added).

* * * * * *

Q. [Coltec's Counsel:] And do you believe that Garrison played any role in the deal you were able to make in the

acquisition by Goodrich?
A. [Mr. Guffey:] It would be my opinion absolutely yes.

TR 86; *see also* TR 83-85, 135-36, 160-61.

In 1996, Coltec's tax liabilities resulting from the sale of Holley Automotive of approximately $100 million paled in comparison with the potential payment of $371.2 million plus for contingent asbestos liabilities, possible bankruptcy of Anchor and Garlock, and impairment of Coltec's ability to sell the entire company intact. DX 1000 at 15 ("[T]he pressing strategic challenge [for Coltec] was to prevent plaintiffs who had sued Anchor from piercing its corporate veil or proving successor liability and dragging Coltec, Garrison, Garlock, or all three into litigation."); JX 1; TR 254.[21] Moreover, the court does not consider the expenses of $1 million for attorney, accounting, and other expert fees to implement Garrison to be excessive given what was at stake. AR 160-63.

For all of these reasons, the court has determined that the record establishes by a clear preponderance of the evidence that the principal purpose of Coltec entering into the Garrison

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[21] *See* Rand, at 87 ("[A]s the litigation has spread . . . the culpability of the defendants called upon to pay asbestos victims is in more dispute. In this context, the issue is not *whether* asbestos victims should be able to receive compensation from some entity, but rather *what entity* should fairly be called upon to shoulder the financial burden."); WLF Asbestos Litigation, at 2 (quoting Robert Vagley, American Insurance Association: "Even companies that once owned a subsidiary which prior to the time they owned it may have used, sold, or distributed products containing asbestos, are now being targeted."); *see also id.* at 10 (emphasis added) (quoting William T. Gallagher, Senior Vice President and General Counsel, Crown, Cork & Seal: "As General Counsel of a manufacturing company . . . I've found my time taken up helping to defend our company against the greatest mass litigation in the history of mankind arising from *a product our company never manufactured and related to exposure to another company's asbestos products that occurred before almost every man and woman working for our company finished school.*").

transaction was not solely to avoid federal income tax, in light of the highly uncertain legal environment in which Coltec was attempting to conduct business. *See* GEVURTZ § 1.5, at 70 (emphasis added) ("*[P]iercing claims constitute the single most litigated area in corporate law.* . . . It is therefore especially unfortunate that . . . judicial opinions in this area have made it one of the most befuddled.").

ii. The "Business Purpose" Test.

Estate of Kanter v. Commissioner, 337 F.3d 833 (7th Cir. 2003) was the principal case relied on by the Government to establish the parameters of the "business purpose" test under Section 357(b). *Estate of Kanter* concerned six different tax deficiencies that arose from the probate of an estate. One of the challenged deficiencies concerned a transaction where an inactive shelf corporation was used to receive real estate partnership interests in exchange for common and preferred stock. *Id.* at 863. Eight promissory notes with a face value of $498,500, dated May 1, 1983 but payable on August 1, 1983, were transferred to the shelf corporation. *Id.* The taxpayer argued that the notes had a basis equal to their face value which increased the total aggregate basis of the real estate partnership, so that the gain, otherwise realized under 26 U.S.C. § 357(c), would be eliminated. *Id.* Stock in the shelf corporation then was sold to a third party real estate developer for $1.5 million in promissory notes. *Id.* at 863-64. When the dust settled, the developer and new owner of the shelf corporation held all of the stock, real estate partnership, and $498,500 cash derived from payments on the notes. *Id.* at 864.

The United States Court of Appeals for the Seventh Circuit characterized the taxpayer's argument, that the principal purpose of this transaction was not to avoid federal income tax and that it had a *bona fide* business purpose, as "meritless:"

> Within a four-month period of time an inactive shelf corporation controlled by [the taxpayer] had its stock transferred three times, twice between [taxpayer]-controlled entities. Within that same time span, promissory notes, virtually equal in total value to the total negative capital account balances, were made by entities controlled by [the taxpayer], transferred . . . to entities controlled by [the taxpayer] and then satisfied by entities controlled by [the taxpayer]. Both [the shelf corporation] and the promissory notes completed their entire useful life-cycle within the span of the larger, intended transaction—transferring the real estate partnership interests to [a real estate developer]. . . . [T]he entire transaction was constructed to avoid the recognition of the gain realized on the assumption of the real estate partnerships' liabilities (by, ultimately, [the real estate developer]). Therefore, the assumption of those liabilities by [the shelf corporation] in the initial stages of the process cannot be described as other than having as its principal purpose the avoidance of federal income tax. *See* 26 U.S.C. § 357(b). . . . The fact that the liabilities being contributed were "ordinary business liabilities of the partnerships" does nothing to save this transaction. As noted, the entire business of contributing the partnership interests and their associated liabilities to [the shelf corporation] was a transaction whose only function was the avoidance of federal tax.

Kanter, 337 F.3d at 865-66.

The court has identified four other federal appellate courts that also have considered Section 357(b) or its predecessors in the six cases; however, they are "so varied in their fact situations that it is difficult to classify and reconcile them." *Jewell*, 330 F.2d at 767. Nevertheless, these cases are summarized here in brief since they represent what appellate

authority exists regarding Section 357(b)'s "business purpose" test.

The most recent consideration of Section 357(b) was in *Drybrough v. Commissioner*, 376 F.2d 350 (6th Cir.1967), wherein the United States Court of Appeals for the Sixth Circuit determined that the "business purpose" test was satisfied where:

> For many years [the taxpayer] was engaged in the business of buying and holding downtown . . . real estate, and operating those holdings in various enterprises such as parking lots. The conversion of these businesses into corporate form was clearly to serve a bona fide business purpose. What was done here was substantially the 'garden variety' of tax free exchange—the shift of a proprietorship to a wholly owned corporation which assumed the debts of the proprietorship.

Id. at 358. In reaching this conclusion, this federal appellate court relied on *W.H.B. Simpson v. Commissioner*, 43 T.C. 900, 1965 WL 1246 (1965), holding that a determining factor was that the taxpayer "did not incur the liabilities to which the transferred securities were subject *immediately prior to the transfer and* solely in *anticipation thereof.*" *Id.* at 917 (emphasis added).

In *Campbell v. Wheeler*, 342 F.2d 837 (5th Cir.1965), the United States Court of Appeals for the Fifth Circuit examined a situation where, in order to satisfy a tax obligation, the taxpayer borrowed $12,000 from a bank, secured by a three percent interest in a corporation and a separate partnership. *Id.* at 839. Both entities were transferred to a new corporation in exchange for stock and assumption of a personal note with interest. *Id.* That federal appellate court held that the assumption of the note was "boot" to the taxpayer and therefore was required to be recognized under Section 357(b), since "payment of one's personal tax liability, even if it is

derived in part from business enterprises, is a purely personal obligation. We do not perceive how, . . . facilitation of [the note's] payment can be a bona fide business purpose for arranging an assumption of the taxpayer's personal note by a controlled corporation." *Id.* at 840-41.

The taxpayer, in *Bryan v. Commissioner*, 281 F.2d 238 (4th Cir.1960), *cert. denied*, 364 U.S. 931, 81 S.Ct. 378, 5 L.Ed.2d 364 (1961), purchased four tracts of land for $1,485,701.96, on which he constructed houses with $1,692,350 from FHA mortgage insurance that later was purchased by the Federal National Mortgage Association. *Id.* at 241. The taxpayer also secured construction loans in the same amount, from which he took advances over time up to the amount of $1,643,500, which exceeded his actual costs by $157,798.04. *Id.* Next, four corporations were created to which the four tracts of land were conveyed in exchange for $500 stock from each corporation and their proportional assumption of the construction loan. *Id.* at 241-42. These corporations then borrowed $1,692,350 from a bank, secured by notes of deed and trust and the taxpayer's personal guarantee. *Id.* at 242. The taxpayer's initial personal loans of $157,798.04 were paid off by selling the proceeds of the corporation's loans. *Id.* Clearly, in that case, the payment of the taxpayer's personal indebtedness was recognized to have "no business connection with the property." *Bryan*, 281 F.2d at 242. Moreover, the taxpayer's argument that the assumption of indebtedness was not "other property" was rejected and, instead, the United States Court of Appeals for the Fourth Circuit held that the taxpayer's "only purpose was to appropriate to himself a major portion of the excess funds which had been committed by FHA and FNMA, and to do it in a form which gives him hope of avoiding federal taxes on the funds with which he enriched himself." *Id.*

The United States Court of Appeals for the Ninth Circuit has considered three cases where the applicability of Section

357(b) was at issue. In *Wolf v. Commissioner*, 357 F.2d 483 (9th Cir.1966), the merits of *bona fide* business purpose were not directly addressed, but rather this federal appellate court held there can be no exchange under Section 351 where assumption of taxpayer's personal liability is at issue. *Id.* at 485-86 ("The purpose of the transaction was essentially an escape of a tax upon a dividend[.]"). In *Jewell*, however, a taxpayer and co-partner dissolved their partnership and organized a corporation that assumed liabilities and issued notes to replace those of the corporation. *Jewell*, 330 F.2d at 763. To date, the payments made by the corporation and a note, replacing the taxpayer's notes, were held not to constitute a constructive dividend, so the court declined to consider whether the transaction had a *bona fide* business purpose. *Id.* at 767. Finally, in *Easson v. Commissioner*, 294 F.2d 653 (9th Cir.1961), a taxpayer's exchange of an apartment encumbered with a mortgage that exceeded taxpayer's basis in the capital stock of the corporation was determined to have a legitimate business purpose under a predecessor statute to Section 357(b). *Id.* at 660-61.

To date, the United States Court of Appeals for the Federal Circuit has not addressed directly the requirements of Section 357(b) and, as discussed above, other federal appellate precedent is sparse; nevertheless, a few principles can be derived that are applicable to the Garrison transaction. First, business purpose is to be examined "narrow[ly] to a purpose '*with respect to the assumption*' [of a liability] and to a purpose to avoid income tax 'on the exchange.'" *Drybrough*, 376 F.2d at 356; *see also* A-TR 84. Second, the closer the nature of the liabilities to the customary business of the transferee and its continued viability, the more likely that Section 357(b)'s principle "business purpose" test will be satisfied. *Id.; see also* Treas. Reg. § 1.368-2(g) (stating that to qualify as a reorganization, a transaction "must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization."). Third, if the liabilities were

incurred well before the transfer of stock, the more likely it is they will be considered as incurred for a business purpose and not tax avoidance. *See, e.g., Drybrough*, 376 F.2d at 358; *Easson,* 294 F.2d at 659. Fourth, the longer the life span of the corporate vehicle utilized and term of any promissory notes issued, the more likely a court will find the transaction to have been undertaken for a "business purpose." *See, e.g., Gregory*, 293 U.S. at 469-70, 55 S.Ct. 266; *Estate of Kanter*, 337 F.3d at 865-66.

The contingent asbestos liabilities assumed clearly were related to Anchor's, Garlock's, and Garrison's ordinary business, and the management and minimization of such liabilities were essential to the continued viability of Anchor and potentially Garlock.[22] Therefore, "[t]he conversion of these businesses into corporate form was clearly to serve a *bona fide* business purpose." *Drybrough*, 376 F.2d at 358 (emphasis added). The events that gave rise to these contingent liabilities, however, took place well before the Garrison transaction. In addition, the facts that the Stemco promissory note had a 15-year term and that Garlock, Stemco, and Garrison continue to function today—eight years after the formation-[sic] of Garrison also weigh in favor of the Garrison transaction being viewed as having a *bona fide* business purpose. And, the separate Garrison structure became an important factor in Coltec's ability to sell the company to B.F. Goodrich Corporation in 1999. TR 135-36, 160-61. Accordingly, for these reasons, the court has

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[22] "U.S. defendants have spent from $20 billion to $24 billion on asbestos litigation through 2000. In their bankruptcy filings and related documents, corporations filing for bankruptcy have reported expenditures (including costs recovered from insurance) ranging from $450 million to $5 billion. We are aware of at least five defendants who have each spent more than a billion dollars a piece . . . A very much larger group of defendants has spent relatively small amounts, but in the aggregate they add up to several billions of dollars." Rand, at 55.

determined that the record in this case establishes that Garrison's assumption of Garlock's contingent asbestos liabilities had a "*bona fide*" business purpose that satisfied Section 357(b) by a clear preponderance of the evidence.

c. The Effect Of 26 U.S.C. § 357(c)(3)(A)(i).

In the alternative, assuming *arguendo* that the Garlock contingent liabilities assumed by Garrison are subject to Section 358(d)(1), Garlock's basis is not required to be reduced under 26 U.S.C. § 357(c)(3)(A)(i), because it excludes liabilities that prior to the Section 351 exchange "would give rise to a deduction." 26 U.S.C. § 357(c)(3)(A)(i).[23]

Prior to the Garrison transaction, Garlock treated accrued and paid asbestos liabilities as ordinary and necessary business expenses. Compl. Exh. I; A-TR 8-10, 13; *see also* Rev. Rul. 95-74, 1995-2 C.B. 36 (stating that liabilities assumed by a newly-formed subsidiary in a Section 351 exchange are not liabilities for purposes of Section 357(c)(1) and Section 358(d) because the liability had not been taken into account by the parent corporation before the transfer, but instead are deductible by the subsidiary as ordinary and necessary business expenses under Section 162(a)). Nevertheless, the Government maintains that Garlock, rather than Garrison, may claim the Section 162(a) deduction after the Section 351 exchange, because it also retains the underlying liability. A-

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[23] Since the court has determined that the "principal purpose" of Garrison's assumption of Garlock's liabilities was not to avoid taxes and the assumption had a proper business purpose, it is not necessary to resolve Coltec's alternative argument regarding the relevance of Field Service Advice 1999-05-008 ("I.R.C. § 357(c)(3) . . . does not contain an exception for I.R.C. § 357(b). Thus, even if I.R.C. § 357(b) applied SI [Garlock] would not be required to reduce the basis of its S2 [Garrison] stock by the amount of the contingent liabilities assumed. Consequently, we do not believe that the application of I.R.C. § 357(b) will cause SI [Garlock] to reduce the basis of its S2 [Garrison] stock by any liabilities assumed").

TR 102-03. The Government, however, ignores the fact that Garrison legally assumed Garlock's contingent asbestos liabilities, which will be paid, only if and when they accrue, first from any Anchor insurance proceeds transferred to Garrison and then from the interest payments made on the Stemco Note. A-TR 102-03. As Professor Ginsburg's treatise recognizes, however:

> the transferee [Garrison] should be entitled to deduct the contingent liabilities as they become fixed and determinable, in accordance with its method of accounting, to the extent that the contingent liabilities would have been deductible [prior to the exchange] by [Garlock]. *See* Rev. Rul. 95-74.[24] The assumed contingent liabilities are not treated as part of [Garrison's] basis in the acquired assets and [Garlock] (as opposed to [Garrison])

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[24] At the Post-Trial Argument, the Government attempted to distinguish Rev. Rul. 95-74 from the Garrison capitalization on the basis that Garlock transferred only liabilities and the Stemco Note to a closely-held entity, Garrison, while the taxpayer in Rev. Rul. 95-74 transferred an entire business, including liabilities, to an unrelated entity. A-TR at 197-99. In Rev. Rul. 95-74, a corporation (P) transferred substantially all of its assets associated with its manufacturing business to a newly-formed subsidiary (S) in a valid Section 351 transaction, in exchange for all the stock of S and S's assumption of the liabilities associated with the manufacturing business. Rev. Rul. 95-74, 1995-2 C.B. at 36. In order to remediate the liabilities, S incurred costs considered ordinary and necessary business expenses deductible under Section 162(a). *Id.* at 36-37. The IRS determined that because the liabilities had not been deducted by P before they were transferred to S, they were not liabilities for purposes of Sections 357(c)(1) and 358(d). *Id.* at 38.

The Government, however, argued that only Garlock, rather than Garrison, is entitled to take deductions under Section 162(a) for the liabilities, as they are accrued, and therefore do not satisfy the requirements of Section 357(c)(3). *Id.* The court discerns no material facts that would preclude Coltec from relying on Rev. Rul. 95-74, since Garlock's contingent liabilities were not deducted prior to the Section 351 exchange, like (P) in Rev. Rul. 95-74.

> is not entitled to take any deduction as the assumed contingent liabilities become fixed and determinable. *See* [26 U.S.C.] § 362.

Ginsburg & Levin ¶ 901.1.3; *see also* Bittker & Eustice ¶¶ 3.06[4][c], 3.06[7], and 3.10[3]; A-TR 182-84.

Another federal trial court recently recognized that "Section 357(c)(3)(A) does not explicitly state whether contingent liabilities must be deductible by the transferor or a transferee in a § 351 exchange to fall within the exception." *Black & Decker Corp. v. United States*, 2004 WL 2051215 (D.Md. Aug. 3, 2004). In that case, a United States District Court resolved this issue by looking to the legislative history. *Id.* at *3 (finding no support for the Government's contention that "§ 357(c)(3)(A) requires that contingent liabilities assumed by a transferee in a Section 351 exchange need not be recognized if the liabilities assumed would have given rise to a deduction for the transferor.").

Whether the analysis is resolved by the statutory approach elected herein or reliance on the legislative history, both federal trial courts have reached the same conclusion. Thus, in this case the contingent nature of Garlock's asbestos liabilities may not be considered in determining Garlock's basis in the Garrison stock since, at the time of the Section 351 exchange, those liabilities had not accrued nor been satisfied. When such liabilities, in fact, accrue and are satisfied, Coltec then may deduct them as ordinary and necessary business expenses, at which time Garlock also must adjust its basis in the Garrison stock. *See* Treas. Reg. 1.1502-32(a), (b)(1)-(b)(3) (requiring determination of parent corporation's basis in subsidiary's stock by adjusting parent corporation's basis to reflect distributions, income, gain, deductions, and losses of subsidiary); A-TR 10-18, 176-78.

3. Other Property.

Next, the Government argues that even if Garlock's contingent asbestos liabilities are not "liabilities" under Section 358(d)(1), they may be treated as "other property" under Section 358(a)(1)(A)(i), requiring a basis reduction. Gov't Post-Trial Memorandum at 13-14.; A-TR 20, 81. A liability is not an asset and therefore is not property or "other property." *See supra* note 20.

4. Determining Basis.

"The basis of property shall be the *cost of* such property[.]" 26 U.S.C. § 1012 (emphasis added).

a. Garlock's Basis In Anchor Stock.

The parties stipulated that Garlock's basis in Anchor stock was $4,206,901. TR 63-65, 76-78, 676-77, 679-84.

b. Garlock's Basis In The Stemco Note.

The August 1, 1996 Stemco Note had a face value of $375 million, a 15 year term, with interest to be paid quarterly, beginning with an initial two-month rate of 8 ¼ % per annum and thereafter fluctuating according to prime. JX 27 at 614811. The Stemco Note was not registered as a security and therefore was not as easily marketed. JX 27 at 614811-21. Coltec advised the court that the $375 million face value includes a $262,751,891 intercompany account payable owed by Stemco to Garlock. A-TR 21-23. At trial, however, Coltec never established the origins or *bona fides* of this account payable and Guffey testified that neither Stemco nor Garlock provided each other with products or services. TR 93-94, 257-68. Andolino had no knowledge of this account payable either. TR 181-82. Moreover, the *bona fides* of the $112,248,109 balance, the court was advised should be treated as a "distribution" from Stemco to its parent company Garlock, likewise was never established by Coltec, nor challenged by the Government. TR 168-87, 265.

Stemco's 1995 year-end balance sheet showed assets of $117 million and liabilities of $60 million. JX10 at BA0284. Stemco also reported less than $38 million in retained earnings on its books and therefore appeared not to have sufficient earnings to operate the company and also pay the approximate $30 million of interest that would be due Garrison each year on the Stemco Note. JX 10 at BA0284; TR 1193-94. Because Stemco's ability to pay the interest was in question, a Garlock Note of almost $315 million was issued, made payable upon demand with interest at 8%. JX 31; TR 265-68. The Garlock Note, however, was unsecured, so that in the event Garlock defaulted and if Stemco demanded payment, Stemco could not have attached any of Garlock's assets. Therefore, whether Garlock in fact assumed "genuine" liability for the Stemco Note, remained an unanswered question to the court. A-TR 34-36. More importantly, whether Stemco could or ever would demand payment of the Garlock Note, because of Coltec's control over both entities, is also an issue that was not resolved to the court's satisfaction. *See Peracchi*, 143 F.3d at 492-93 ("[A]ll [the taxpayer] did was make out a promise to pay on a piece of paper, mark it in the corporate minutes and enter it on the corporate books. It is also true that nothing will cause the corporation to enforce the note against [the taxpayer] so long as [the taxpayer] remains in control."). The record in this case establishes that Garlock had sufficient operating revenues to support payment of the interest and confirms that Garlock, in fact, made all interest payments due to Stemco, thereby providing Stemco with sufficient funds to pay interest due to Garrison. JX 89, 106, 108, 110; PX 425; TR 257, 454-56, 1204-07; A-TR 159. Moreover, the enforceability of the Stemco and Garlock Notes was not questioned by the Government's expert, Dr. Kolbe. PX 163 at G16583; TR 2346-47; A-TR 24-27.

At the Post-Trial Argument, the court indicated that it continued to be troubled about the basis attributed to the Stemco Note because of concerns about whether the Garlock Note

could or would be enforced by Stemco in light of Coltec's ability to control Stemco and Garlock. A-TR 19, 23-24, 28-29, 32, 74, 103, 191.[25] Rather than challenge the basis determination as not reflecting the "cost" of the Note,[26] instead the Government decided that this issue "factors into the analysis, primarily in the economic substance element of

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[25] The Government's expert, Dr. Raymond J. Ball, the Sidney Davidson Professor of Accounting in the Graduate School of Business at the University of Chicago, persuasively testified that it was not appropriate under generally accepted accounting principles to treat the transfer of the Stemco Note as a contribution of an asset and as a contribution to the capital of Garrison. DX 440 at GOV 0460, 0466-67; DX 691; TR 1998-2009. Dr. Ball further advised the court that Emerging Issues Task Force (EITF) No. 85-1 states: "reporting the note as an asset is generally not appropriate, except in very limited circumstances when there is substantial evidence of ability and intent to pay within a reasonably short period of time. Some Task Force members would require collateralization, or payment of the note prior to issuance of the financial statements, to permit asset recognition." JX 89 at 0092; DX 440 at GOV 0467. Instead, Dr. Ball testified that "[t]he appropriate accounting is to record the Note as exactly offsetting the amount of new share capital issued to Garlock in exchange for it." DX 440 at GOV 0470. That amount would be $10 million. DX 440 at GOV 0468 (citing Garrison 1996 financial report footnote). Indeed, for this reason, Coltec's auditor Arthur Andersen issued a restricted opinion, which states that: "Garrison's note does not meet the criteria [EITF No. 85-1], as the note is unsecured and longer term. Due to the tax sensitivity of this transaction, the client is not willing to classify the note receivable as an offset to equity." DX 440 at GOV 0468.

On the other hand, the court also heard credible testimony from Coltec's expert, Professor Jones, to the effect that GAAP and the tax rules are different. TX 9; TR 2652-82; *see also Lyon*, 435 U.S. at 577, 98 S.Ct. 1291 ("[T]he characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same.").

[26] As Dr. Ball testified, the issuance of the Stemco promissory note was not conducted at arm's length, but instead between subsidiaries with a common parent, therefore, $375 million did not represent the note's fair market value. DX 440 at GOV 0469-70.

the agreement." A-TR 104. Since the Government stipulated at the Post-Trial Argument that Garlock's basis in the Stemco Note was $375 million, the court must so hold, but with continued skepticism.[27] A-TR 131, 191-92.

c. Garlock's Basis In Garrison Stock.

If property was acquired after June 22, 1954 by a corporation in connection with a transaction to which Section 351 applies, "the basis [of property received] shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer." 26 U.S.C. § 362(a)(1); *see also* 26 U.S.C. § 358(a)(1).

In this case, Garlock's basis in the Garrison stock is the sum of the $4,206,901 basis in the Anchor stock and the $375 million stipulated basis in the Stemco Note, *i.e.*, $379,206,901.

5. Garlock's Transaction With The Banks Was A Bona Fide Sale Of Property.

Section 1001(c) requires that "the entire amount of the gain or loss . . . on the sale or exchange of property shall be recognized." Therefore, the first relevant inquiry is whether the terms of the Shareholders Agreement affected Garrison stock so that it no longer was property. The second inquiry is whether the transfer of Garrison stock to the Banks in exchange for $500,000 was a sale.

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[27] The lack of convincing documentation about the origins and *bona fides* of the intra-company transactions and the issue of Coltec's control over the creation of and potential enforcement of both the Stemco and Garlock Notes is an area that the Government did not aggressively pursue to its detriment. A-TR 127-33. The court is aware that promissory notes generally are assigned basis at face value, but the import of Coltec's control in this case made this an appropriate vehicle to test how "cost" should be determined in intra-company transactions. Rather than tackle that legal issue directly under 26 U.S.C. § 1012, however, the Government asks the court to abandon statutory moorings for the "open seas" of equitable doctrine.

a. The December 20, 1996 Shareholders Agreement Between Coltec And The Banks Did Not Affect The Property Rights That The Banks Obtained In Garrison Stock.

i. The Property Garlock Transferred To The Banks Was "Stock."

It is well established that stock is considered property for federal income tax purposes. *See, e.g., Peracchi*, 143 F.3d at 489; *E.I. DuPont de Nemours & Co.*, 471 F.2d at 1211. Stock is defined as "the permanent proprietary ownership or equity interest in a corporation, entitling the holder to (1) share proportionately in the profits of the business; (2) vote on matters affecting the corporate enterprise; and (3) share ratably in the assets of the venture (after payment of debts) upon liquidation[.]" Bittker & Eustice ¶ 12.41[2], at 12-185; *see also* Harry G. Henn and John R. Alexander, Laws of Corporations 396 (3d ed.1983) ("Henn") (defining stock or shares by "a three-fold proportionate interest in the corporation with respect to: (a) earnings, (b) net assets, and (c) control."). The record is clear that Garrison stock certificates were delivered by Garlock to the Banks, pursuant to the requirements of the December 20, 1996 Stock Purchase Agreement, together with all attendant rights. JX 76. In exchange, the Banks paid Garlock $500,000. JX 76. The Government, however, suggested for the first time at the Post-Trial Argument that Garlock's transfer of Garrison stock to the Banks was simply a "loan of a certificate to an accommodating party for a period of time to create an argument that there has been a sale or exchange upon which [Garlock's] basis can be recognized[.]" A-TR 107; *see also* TR 110; *compare with* Gov't Post-Trial Memorandum. The court cannot discern how the stock certificates were "loaned," based on the record.

The Garrison certificates were transferred, pursuant to the December 20, 1996 Stock Purchase Agreement, between Garlock and the Banks, for which the Banks collectively paid Garlock $500,000 as consideration. The December 20, 1996

Shareholders Agreement was a separate contract between Coltec and the Banks, pursuant to which the Banks were offered the opportunity to make substantial profit, if and when certain put and call options were exercised and to obtain access to confidential information regarding Garrison, in exchange for the Banks' agreement to obtain prior written consent from Coltec before transferring the Garrison stock to another party. JX 75; TR 2172-73. The "put" and "call" options were separate contractual rights distinct from the property interest that the Banks acquired in the Garrison stock. *See* Filer, at 9, 57. For this reason, "the federal tax consequences of an option's issuance are not recognized until the option lapses or is exercised." *Id.* at 108. The fact that the Banks never exercised their put option is irrelevant to whether they owned the Garrison stock, *i.e.*, exercised "power and control over the . . . property . . . 'taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed the actual benefit for which the tax is paid.'" *Commissioner v. Sunnen*, 333 U.S. 591, 604-05, 68 S.Ct. 715, 92 L.Ed. 898 (1948) (internal citation omitted). Likewise, the fact that Coltec did not exercise its call option did not affect the Banks' property rights in the Garrison stock. In addition, the Banks' promise not to transfer the Garrison stock without prior approval of Coltec also does not affect the Banks' property rights in and ownership of the Garrison stock. JX 75 at § 2.1. When Garlock relinquished physical control and title over the Garrison stock it "shift[ed] the incidence of income tax liability." *Sunnen*, 333 U.S. at 610, 68 S.Ct. 715 (holding that a taxpayer's assignment of license contracts to his wife was not a sale where he retained the power to control the payment of royalties, as well as ownership in the underlying patents); A-TR 44. In fact, the Banks could have sold Garrison stock to a third party without seeking Coltec's approval, and the third party could have taken title to the Garrison stock. Coltec would have no action against the third party, but instead

would have to sue the Banks for a breach of the Shareholders Agreement for damages. *See* E. Allan Farnsworth, Farnsworth on Contracts § 11.8 (3d ed.2004) (stating that a claim for breach of contract cannot be used to impose liability on the third-party unless the third-party has assumed the assignor's duty of performance).

The Government's expert, Dr. McDonald, testified that the Garrison stock owned by Garlock and Coltec was "different" than that held by the Banks in several key respects. DX 1014 at §§ 3.2-3.3; TR 2186-87, 2193. First, the put option increased the marketability of what otherwise was a minority block of common stock. TR 2183-87. Second, Coltec's agreement to indemnify the Banks made the Garrison stock more attractive. TR 2203-05. Thus, Dr. McDonald concluded that the Garrison stock held by the Banks was not stock, but rather a default free, highly rated bond. TR 2167-68; A-TR 106. In the alternative, Dr. McDonald testified that the Garrison stock could be viewed as a hybrid security, *i.e.*, one that combines the features of debt securities and stock. Henn, at 409. "Where the maturity and return are both fixed, [for tax purposes,] usually a debt obligation is found." *Id.* at 410. If neither a maturity date or return are fixed, the security usually is treated as stock. *Id.; see also id.* at 411. In this case, however, the Garrison stock did not have either a maturity date or a fixed return. PX 166; A-TR 169-71. Moreover, Section 1001(c) is concerned with "property," which could include stock, bonds, or hybrid securities.

Therefore, the court has determined that the Banks secured all property rights in and ownership of Garrison stock on December 20, 1996, by virtue of the Stock Purchase Agreement. JX 76. The separate Shareholders Agreement did not negate the legal or economic significance of the property rights that the Banks acquired in Garrison stock, as further evidenced by the fact that the Garrison stock is still owned and controlled by the Banks. JX 75; A-TR 174.

ii. The Transaction Between Garlock And The Banks Was A "Sale" Of Garrison Stock.

Neither the language nor the history of the Code defines a "sale." In general, a "sale" is defined "in the ordinary sense of the word, [as] a transfer of property for a fixed price in money or its equivalent." *State of Iowa v. McFarland*, 110 U.S. 471, 478, 4 S.Ct. 210, 28 L.Ed. 198 (1884); *see also* Black's Law Dictionary 1337 (7th ed.1999) ("[t]he transfer of property or title for a price.").

The Government asserts that whether a sale has occurred is "an issue of law which the courts generally have resolved through evaluation of the facts of the individual case." Gov't Post-Trial Memorandum at 35. The court is advised that the key to that determination in this case is "whether a particular transaction is properly characterized as a sale is [a] determination of whether the benefits and burdens of ownership have passed from the seller to the buyer. There is an issue of fact to be determined by examination of the relationship created by the parties through the operative legal documents." *Id.* Accordingly, the Government initially listed a number of indicia that it argued evidence that the transfer of the Garrison stock to the Banks was not a "sale." Most of these indicia, however, simply are not relevant to whether property was transferred for a price. To illustrate this point, the Government's contention first is stated, followed then by the court's response:

- "the Garrison shares acquired by the Banks represented a small minority interest in a closely-held corporation." Gov't Pre-Trial Memorandum at 31.

  The amount of stock transferred is not relevant to whether a sale occurs.

- "as Garrison did not pay dividends, the Banks' only opportunity to profit from the Garrison shares was

through the transfer of the shares to another buyer." Gov't Pre-Trial Memorandum at 31.

Whether or not a corporation decides to pay dividends is not relevant to whether a sale occurs nor whether or not a purchaser profits by the acquisition of such stock. *See Cottage Savings,* 499 U.S. at 563, 111 S.Ct. 1503 (citation omitted) (stating that a "stock dividend merely reflected the increased worth in the taxpayer's stock and that a taxpayer realizes increased worth of property only by receiving 'something of exchangeable value [.]'"). In fact, many corporations that do not declare dividends and that never produce a "profit" for their stockholders. *See* Henn § 327, at 913 ("The distribution of dividends . . . is usually discretionary, within the business judgment of the board of directors.").

- "the Banks could sell their Garrison shares only with Coltec's approval." Gov't Pre-Trial Memorandum at 31.

  A right of refusal, however, does not negate the transfer of title. It simply makes the stock more difficult to remarket. *See* Henn § 281, at 758 (share transfer restrictions "preventing outsiders from obtaining ownership in the corporation . . . are ordinarily recognized as proper.").

- "as a practical matter, Coltec was the only possible buyer for the Garrison shares." Gov't Pre-Trial Memorandum at 31.

  The record reflects that the Banks were the only sophisticated investors or financial institutions that Coltec was able to locate, during the period September 13, 1996 to December 31, 1996, willing to purchase Garrison stock. TR 126-27. There is no evidence in this record that "Coltec was the *only* possible buyer." Gov't Pre-Trial Memorandum at 31 (emphasis added).

- "the anticipated exit strategy for the Banks was through exercise of the put and call options in five years, with Coltec (or its designee) reacquiring the shares." Gov't Pre-Trial Memorandum at 31.

  Whether the banks had an exit strategy or not has no bearing on whether Garrison stock was sold to them. In fact, "[b]y far the most common [share transfer] restriction is that making use of an option provision. Typically, they provide that a shareholder must offer the shares to the corporation . . . before transferring the shares to an outsider. They might also provide for a binding buy-sell agreement with the corporation . . . exercisable upon a specified event." Henn § 281, at 758.

- "analysis of the formulas established for the exercise price for the options created a high likelihood that Coltec would reacquire the shares at a pre-set fixed price ($40/share), regardless of Garrison's fortunes." Gov't Pre-Trial Memorandum at 31.

  The fact that Coltec did not exercise its option to repurchase the Garrison stock, however, was anticipated by the Banks and factored into the price paid, but had no bearing on whether the Garrison stock was sold. And, as Coltec notes: "The fact that the Banks now continue to own the stock (with all options expired) conclusively disproves the argument that the stock was not sold." Coltec Post-Trial Brief at 18; *see also* Henn § 176 at 446 ("The record ownership of securities, both debt and other securities in registered form, as well as shares, is conclusive evidence of such ownership for many purposes."); *see also* TR 304-05, 1521, 1530, 2612-13.

- "the only other realistic possible outcome was that the Banks would get nothing if Garrison became economically insolvent." Gov't Pre-Trial Memorandum at 31.

Certainly, if Garrison became insolvent, the Banks likely would receive nothing from a bankruptcy proceeding, but Garrison, in fact, did not become insolvent. Moreover, the potential for insolvency does not affect whether property was transferred for a price.

- "the Banks were given no significant role in operating or managing Garrison." Gov't Pre-Trial Memorandum at 31.

  The Banks purchased a minority interest in Garrison and therefore would have no right to control or have a significant role in operating or managing Garrison. *See* Henn § 188, at 490-91 ("In a strict sense, management of the business and affairs of a corporation is under the direction of its board of directors, and shareholders have no functions of management as such.").

- "Coltec agreed to indemnify the Banks from liability in the event of any asbestos claimant successfully pierced Garrison's corporate veil." Gov't Pre-Trial Memorandum at 31.

  Coltec's indemnification, however, cuts against the Government and supports Coltec's position that a sale took place because, if the Banks did not have a property right in Garrison stock, they would have no basis for concern about an asbestos claim or piercing the corporate veil.

- "Coltec agreed to keep secret the Banks' position as Garrison shareholders." Gov't Pre-Trial Memorandum at 31.

  Whether the transaction was secret or a matter of public knowledge has no bearing on whether the Banks collectively paid Coltec $500,000 for Garrison stock.

This initial list of indicia was reduced and restated after trial, when the Government argued that the evidence showed that a "sale" of equity would have provided the Banks with:

> (1) a *pro rata* share in the fortunes of the underlying venture,
>
> (2) the ability to sell or transfer holdings to other parties,
>
> (3) the ability to influence the management and governance of the venture,
>
> (4) ownership rights for the lifetime of the venture,
>
> (5) the potential for liability if the corporate veil is pierced.

Gov't Post-Trial Memorandum at 35.

A few additional comments are warranted. First, the Garrison stock purchased by the Banks entitled them to a proportionate distribution, like any other shareholder, if Garrison was liquidated. Second, the Banks were not restricted from selling Garrison stock to another party. The Banks simply had to provide Coltec with notice, so it could protect its interests regarding Garrison's business of managing Garlock's asbestos liability issues. Third, the Banks held a minority position in Garrison and therefore had no ability to control Garrison management, nor was this unusual. Fourth, the Banks certainly had ownership rights for the life of the venture—and still do. And, fifth, the Banks sufficiently were concerned about veil piercing that they too formed separate corporations to insulate their main business and required further indemnification from Coltec.

Before trial, the Government argued that "Coltec's economic relationship with the Banks is best viewed as a constructive non-sale." Gov't Pre-Trial Memorandum at 31. The transfer of Garrison shares to the banks was characterized as a "constructive non-sale," based on Dr. McDonald's conclusion that the "exit strategy" anticipated that Coltec

would reacquire the Garrison stock in five years and hence the transfer was not genuine, but only one "primarily a matter of form." *Id.* at 31-32. Dr. McDonald relied on Dr. Kolbe's probability model, which indicated that it was highly likely that the put price of the stock under the Shareholders Agreement would be more than $40 when the put option could be exercised after five years, and that the shares would be purchased at the call price of $40. DX 1014 at 22, 25-27; TR 1913, 2226. Dr. Kolbe, however, was not cognizant of the fact that Coltec had no legal obligation to buy back the stock from the Banks at $40, or at any price, unless the Banks exercised their put options. JX 75 at § 3.3; TR 289, 1984-86; A-TR 172. Accordingly, after hearing all of the testimony at trial,[28] Dr. McDonald stated that "there is . . . more probability than I realized at the outset that there might have been a price below $40" [TR 2217] and that "there seems to be a greater amount of expected value calculations in these scenarios than I had realized," which "implies that there may have been a greater probability of the stock being worth less than $40." TR 2235. Thus, Dr. McDonald reconsidered his initial conclusion stating: "once you allow substantial amounts of risk, I'm not sure I can offer a bright line test for whether a constructive non-sale has occurred." TR 2228. And, so the Government's constructive non-sale theory deconstructed.

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[28] During trial, Dr. McDonald heard Mr. Andolino's testimony about the real-life difficulty of selling Garrison stock because most potential "sophisticated investors" viewed the investment as too risky. TX 7 at ¶¶ 18-25; TR 2453-57, 2464. Dr. McDonald also learned that the Banks rejected the initial offer on the stock, negotiated to obtain better terms, and viewed the investment as highly risky. TX 7 at ¶¶ 18-25; TR 2453-54, 2458-63. Indeed, First Union's representative testified that there was a high likelihood that the put price in five years would be less than $40. TR 1528-29. NationsBank's representative also testified that he thought it was not likely that its stock would be worth $40. TR 1078. In addition, Dr. McDonald learned that the Banks recorded the transaction on their internal books as an investment in equity. TR 1525, 2602-03.

Taking a different tact, Dr. Ball testified that he considered the transfer of Garrison stock to the Banks to be a loan. TR 2001, 2056-59, 2071. The Banks, however, did not treat the purchase as a loan. TR 1525, 2602-03. Dr. Ball's conclusion, however, was premised more on the assumption that the put and call options would be exercised and the Garrison stock would revert to Garlock. TR 2071-77. Unfortunately, Dr. Ball testified that he was advised by the Government that there was a substantial probability that the put would be exercised. TR 206-77. That did not happen. Moreover, as discussed above, the Garrison stock neither had a maturity date nor fixed return. *See* Henn, at 410. Therefore, the court has determined the transfer of Garrison stock to the Banks was not a loan.

For these reasons, the court has determined that the transfer of Garrison stock to the Banks by Garlock was a sale of equity.

b. The Sale Of Garrison Stock To The Banks Was Conducted At Arm's Length.

In *Higgins v. Smith*, 308 U.S. 473, 475-76, 60 S.Ct. 355, 84 L.Ed. 406 (1940), the United States Supreme Court held that a taxpayer's losses were not *bona fide* because "the transaction was not conducted at arm's length and because the taxpayer retained the benefit of the securities[.]" *Cottage Savings Association v. Commissioner*, 499 U.S. 554, 568, 111 S.Ct. 1503, 113 L.Ed.2d 589 (1991). The court has determined in this case that the sale of Garrison stock to the Banks was conducted at arm's length.

The Banks secured counsel and independent outside consultants to conduct due diligence, not only about the business terms, but about the potential that the Banks could find themselves subject to veil piercing claims. TR 316, 1071, 1487, 1496, 1517-19, 2575-76, 2586-88. The terms of the Stock Purchase Agreement between Garlock and the Banks

and the Shareholders Agreement between Coltec and the Banks were subject to intense business negotiations. JX 67 at 2-4, Exh. 3; TR 312-14, 1071-78, 1500, 1514-15, 1520-26, 2579, 2603-04. In fact, on more than one occasion, the transaction appeared to fall apart over the price of the put options. JX 66; PX 136 at COLT 17129-30; TR 311-14, 1500-03, 1514-15, 1522-23, 1534-39, 2604.

Stewart was charged with the task of evaluating the insurance coverage estimated by Kahn. JX 64; TR 510-11, 621-22. Stewart issued a report that concluded:

> [T]he kind of exercise that Kahn Consulting performed to calculate insurance recoveries is reasonable, and, in fact, if asked the same question, we probably would have taken the same approach. But we think its limitations must be understood. Regardless of the accuracy of the Tillinghast projections of claims, the nature of the Kahn Consulting projections of insurance recoveries is that they are best-case estimates and hence the risk is one-sided.

TX 64 at BA 0965. Clearly, the Banks were well advised and on notice that the purchase of Garrison stock was a highly risky investment, a message that was repeated in the December 3, 1996 Offering Memorandum. JX 73 at C273, 278-79, 289; TR 1526-29, 1007-78; *see also* JX 50 at BA 0832; JX 67 at 2. To further protect their concerns about "veil piercing," the Banks required Coltec to indemnify them and to keep the transaction confidential. JX 75 at §§ 5.4-5.5; TR 316-18, 1518-19.[29]

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[29] In addition, KPMG was retained to review the "reasonableness" of the Tillinghast and Kahn Reports. DX 450; PX 145, 150; JX 48; TR 512-13, 517-18, 1486, 1545-52; 1572-77, 1599-1605, 1611, 1701-04, 2708-09. KPMG advised the Banks that "the greatest risk of error lies in the possibility that history will not repeat itself. . . . [Therefore], it is likely that current estimates would underestimate the magnitude of the [Garlock] liability." PX 145 at BA 1054; PX 150 at BOA 819.

The Banks also required an opinion from counsel that the Stemco Note and Garlock Note were enforceable. JX 60 at COLTEC 2248; JX 62 at COLTEC 5146; JX 75 at § 5.4(d); PX 163 at G 16582-87; TR 2597-98. In this case, a fact-based opinion was not rendered by independent outside counsel, but instead by Kronish, Lieb, which was designated on the opinion letter as Coltec's "special counsel." Although that may have been commercially acceptable to the Banks, the opinion remains problematic to the court, particularly in light of its contingent nature and direct dependence on the opinion of Coltec's General Counsel. *See Long Term Capital Holdings v. United States*, 330 F.Supp.2d 122, 146 (D.Conn. 2004) (observing where the opinions contain "no legal reasoning or analysis. [But] [r]ather . . . set out the factual underpinning for the legal conclusions," the court should closely scrutinize the transaction.). The deficiencies in the opinion letter, however, do not change the court's conclusion that the clear weight of the evidence established that the transaction with the Banks was conducted at "arm's length," even though the Banks were most willing to become an investor in Garrison to curry favor with Coltec. But, as Dr. Kolbe, the Government's expert, accurately described this was a "small deal for [the Banks] used to bigger deals." TR 1842.

Accordingly, the court has determined that the negotiations between Coltec, Garlock, and the Banks were conducted at "arm's length."

G. The Court's Resolution Of Issues Concerning The Doctrine Of "Economic Substance."

The "economic substance" doctrine, a composite of the "business purpose" doctrine, the "substance over form" doctrine, and the "sham transaction" doctrine, is said to have evolved from the following dicta in *Gregory:*

> [T]he question for determination is whether what was done, apart from the tax motive, was the thing which the

> statute intended. . . . [F]ixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business [.] . . . No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death. . . . [T]he transaction upon its face lies outside the plain intent of the statute.

Gregory, 293 U.S. at 469-70, 55 S.Ct. 266; *see also ACM Partnership v. Commissioner*, 157 F.3d 231, 247-48 (3d Cir.1998).

A leading tax scholar, however, has observed that:

> It is doubtful that the Supreme Court in *Gregory* intended to create a business purpose requirement of the sort that now encumbers the tax law. . . . Although it is clear enough today that a reorganization must satisfy the business purpose requirement, the exact contours and proper role of the requirement have been the subject of much debate during the more than half century since *Gregory*. It is clear enough that a transaction undertaken solely for tax avoidance purposes will fail the business purpose requirement and consequently will not qualify as a tax-free reorganization. It seems no less clear, if redundant, that a transaction undertaken primarily for valid business purposes will satisfy the business purpose

> requirement. Between these obvious poles resides more than a little uncertainty.

Ginsburg & Levin ¶ 609.1, at 6-205.

As a matter of litigation strategy, the Government clearly anticipated that the court might well conclude that the Garrison transaction and subsequent transactions with the Banks satisfied the requirements of the Code. Therefore, to trump Coltec's navigation of the statutory currents and cross currents discussed herein, the "economic substance" doctrine would have to be invoked for the Government to prevail. A-TR 66.[30] The Government's briefs, however, cited no supporting legal authority from the United States Court of Appeals for the Federal Circuit on this issue. *See* Gov't Pre-Trial Memorandum at 33-34; Gov't Post-Trial Memorandum at 37-39. During oral argument, the court invited the Government to provide that authority. A-TR 123. In response, on October 4, 2004, the Government provided the court with a list of "binding precedent" that "supports the principle that economic substance, and not *mere* formal compliance with the Code, must inform the interpretation and application of the tax law." Oct. 4, 2004 Gov't Supplemental Letter at 1 (emphasis added).

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[30] *See* A-TR 76-77 (Government's Counsel):

> "I understand that tax law is statutory. . . . But when you start looking at it you should look—you should look for a common sense correlation between the tax law and financial accounting and economics, and be very skeptical of someone who tells you that they diverge as much as Coltec does in this case.
>
> What they've told you is that the smart people who came up with this transaction are alchemists. They turn tax gold. They make tax gold out of liability drek.
>
> We all know that the alchemists were lying, that they were fabricating things."

Turning first to cases from the United States Supreme Court, it is certainly true that the Court has decided tax cases invoking doctrine. *See, e.g., Gregory*, 293 U.S. at 469, 55 S.Ct. 266; *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334, 65 S.Ct. 707, 89 L.Ed. 981 (1945) ("A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."). A careful reading of other cases cited by the Government, however, reveals that the Court resolved the tax question at issue first by looking to the Code and utilized doctrinal language only to further support its conclusion. *See, e.g., Commissioner v. Clark*, 489 U.S. 726, 738, 109 S.Ct. 1455, 103 L.Ed.2d 753 (1989) (emphasis added) (wherein the Court relied on "[o]ur reading of the statute . . . [*which*] *is reinforced* by the well established 'step-transaction' doctrine[.]"); *Knetsch v. United States*, 364 U.S. 361, 81 S.Ct. 132, 5 L.Ed.2d 128 (1960) (emphasis added) (in determining "whether the transactions created a true obligation to pay interest[,][u]nless that meaning plainly appears, we will not attribute it to Congress. . . . *We, therefore, look to the statute* . . . to its construction for evidence that Congress meant in § 264(a)(2) to authorize the deduction of payments made under sham transactions entered into before 1954."). *Id.* at 367, 81 S.Ct. 132. Moreover, in none of these cases was the issue raised that, under constitutional separation of powers, judges should determine congressional intent by the language of the Code, rather than deciding what tax policy should be. *See United States v. Fausto*, 484 U.S. 439, 449, 108 S.Ct. 668, 98 L.Ed.2d 830 (1988) (explaining that congressional intent is found in "the statutory language . . . [and] the structure of the statutory scheme"); *see also Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 544-45, 112 S.Ct. 2608, 120 L.Ed.2d 407 (1992) (Scalia, J., concurring in judgment in

part and dissenting in part) ("[O]ur job is to interpret Congress's decrees . . . neither narrowly nor broadly, but in accordance with their apparent meaning. . . . Congress's intent [is] revealed by the text, structure, purposes, and subject matter of the statutes involved."). Moreover, in light of the Court's unanimous opinion in *Nebraska Department of Revenue v. Loewenstein*, 513 U.S. 123, 115 S.Ct. 557, 130 L.Ed.2d 470 (1994) the current vitality of the "economic substance" doctrine certainly is not clear. *Id.* at 134, 115 S.Ct. 557 (emphasis added) (declining to apply the economic substance doctrine and stating: "*[W]hatever the language* [*Frank Lyon Company v. United States*, 435 U.S. 561, 583-84, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978)] . . . *may mean*, our decision in that case . . . was founded on an examination . . . of 27 specific facts.").

The three most recent precedential cases cited by the Government from the United States Court of Appeals for the Federal Circuit also warrant a close reading. In *Holiday Village Shopping Center v. United States*, 773 F.2d 276 (Fed.Cir.1985), the question presented was whether the liquidation of a corporation's interest in a limited partnership was subject to the recapture provisions of federal tax law regarding accelerated depreciation on certain property where a partnership was involved. Thus, the relevant inquiry was whether it was more appropriate to treat the partnership as an aggregate of the partner's institutional interests rather than as a separate entity. *Id.* at 279. In determining that the partnership should be disregarded, "*in this case*," our appellate court merely acknowledged that "[c]ourts, however, will focus on the substance rather than on the form of a transaction where necessary to reflect the economic realities of the situation." *Id.* at 280 (citing *Gregory*) (emphasis added). Without further discussion, much less an endorsement of the economic substance doctrine, the Federal Circuit held only that "it is appropriate in this case to disregard the partnership[.]" *Id.* In light of the fact that the federal

appellate court undertook no analysis of the "economic realities" attributed to *Gregory* and clearly limited its holding to the facts of the case, the court does not discern any directive requiring it to resolve the instant case under the economic substance doctrine.

In *Executive Jet Aviation, Inc. v. United States*, 125 F.3d 1463 (Fed.Cir.1997), the United States Court of Appeals for the Federal Circuit was asked whether a taxpayer was involved in the business of transporting persons or property for hire and therefore was subject to a transportation tax. In affirming a determination by the United States Court of Federal Claims that the plaintiff-appellant was subject to the applicable tax, our appellate court held:

> We begin our analysis with the language of the statute. Where the statute's language is plain, "the sole function of the courts is to enforce it according to its terms." We do not agree that [the [C]ode sections at issue] are ambiguous because they do not define the words "transportation" and "transporting." It is well settled that the legislature's failure to define commonly-used terms does not create ambiguity, because the words in a statute "are deemed to have their ordinarily understood meaning." Moreover, "[t]he plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and . . . ingenuity and study . . . would discover."

Id. at 1468 (citations omitted). After framing "[t]he central question [as] whether EJA was in the 'business of transporting persons or property for hire by air,'" as an aside, the Federal Circuit cited *Gregory* and a footnote, *Terry Haggerty Tire Co., Inc. v. United States*, 899 F.2d 1199, 1201 n. 2 (Fed.Cir.1990), for the proposition that "'for tax purposes the substance rather than the form of a transaction is generally controlling.'" *Id.* at 1469. Albeit that is so, but where the language of the Code is clear, the "substance rather than

form" doctrine is irrelevant. The United States Court of Appeals for the Federal Circuit well understood this when it further held: "[A]bsent a clear showing of contrary legislative intent, the plain meaning analysis of the statutory language begins and ends the judicial inquiry." (citations omitted). *Id.* at 1470; *see also Seggerman Farms, Inc. v. Commissioner*, 308 F.3d 803, 808 (7th Cir.2002) ("Absent any ambiguity on the face of a statute, it is the province of the legislative branch, rather than the judiciary, to safeguard the taxpayer from undue hardship[.]"); *The Limited, Inc. v. Commissioner*, 286 F.3d 324, 336 (6th Cir.2002) ("[I]t is not the [judiciary's] role to inject its own policy determinations into the plain language of statutes."); *Rubin v. Commissioner*, 429 F.2d 650, 653 (2d Cir.1970) ("Resort to 'common law' doctrines of taxation . . . have no place where, as here, there is a statutory provision adequate to deal with the problem presented."). For these reasons, the court discerns no instruction from the United States Supreme Court and the United States Court of Appeals for the Federal Circuit contrary to the analysis and conclusion reached herein regarding the "economic substance" doctrine.

In any event, the court already has considered and held that Coltec satisfied the tax avoidance and business purpose tests in Section 357(b), therefore, *ipso facto*, the "economic substance" doctrine is satisfied, since that doctrine requires proof of at least one of these tests. *See, e.g., Frank Lyon*, 435 U.S. at 583-84, 98 S.Ct. 1291 (holding "[W]here, as here, there is a genuine multi-party transaction with economic substance which is compelled . . . by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties."); *United Parcel Service of America, Inc. v. Commissioner*, 254 F.3d 1014, 1018 (11th Cir.2001) ("This economic-substance doctrine . . . provides that a transaction ceases to merit tax respect when it

has no 'economic effects other than the creation of tax benefits [*i.e.*, tax avoidance].'"); *Northern Indiana Public Service Co. v. Commissioner*, 115 F.3d 506, 512 (7th Cir.1997) ("[The economic substance doctrine] engender[s] the principle that a corporation *and the form of its transactions* are recognizable for tax purposes, despite any tax-avoidance motive, so long as the corporation engages in *bona fide* economically-based business transactions."); *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir.1985) (emphasis added) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by *no business purposes* other than obtaining tax benefits in entering the transaction[.]"); *Black & Decker Corp. v. United States*, No. WDQ-02-2070, 2004 U.S. Dist. LEXIS 21201, at *6 (N.D.Md. Oct. 22, 2004) (holding that a "court may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes."). Moreover, from the "standpoint of the prudent investor," the Garrison transaction not only appeared to place one more barrier in the way of veil piercing claims, but it provided the B.F. Goodrich Corporation with a sufficient comfort level to purchase all of the Coltec Group in 1999. *See Gilman v. Commissioner*, 933 F.2d 143, 147-48 (2d Cir.1991) ("[A] court could either inquire whether there were any non-tax economic effects or use the analysis under Section 183. Whether the terminology used was that of 'economic substance, sham, or Section 183 profit motivation' was not critical; what was important was reliance on objective factors in making the analysis.") (citations omitted); A-TR 137-47, 152-56.

In A Matter of Interpretation: Federal Courts and the Law (1997), Justice Scalia presents a compelling argument that the courts must interpret statutes as Congress wrote them, rather than what they "ought to mean." *Id.* at 3-37. Emphasizing the danger of relying on judicial results-oriented rationale, rather than adhering to the direct of statutory language selected by Congress to express its will, Justice Scalia

reminded judges of the words of an early 19th century legal scholar, who warned:

> Judge-made law is ex post facto law, and therefore unjust. An act is not forbidden by the statute law, but it becomes void by judicial construction. The legislature could not effect this, for the Constitution forbids it. The judiciary shall not usurp legislative power, says the Bill of Rights: yet it not only usurps, but runs riot beyond the confines of legislative power.
>
> Judge-made law is special legislation . . . The judge makes law, by extorting from precedents something which they do not contain. He extends his precedents, which were themselves the extension of others, till, by this accommodating principle, a whole system of law is built up without the authority or interference of the legislator.

Id. at 10-11 (quoting Robert Rantoul, Oration at Scituate (July 4, 1836) in *Kermit L. Hall et al., American Legal History* 317, 317-18 (1991)).

The public must be able to rely on clear and understandable rules established by Congress to ascertain their federal tax obligations. If federal tax laws are applied in an unpredictable and arbitrary manner, albeit by federal judges for the "right" reasons in the "right case," public confidence in the Code and tax enforcement system surely will be further eroded. *See* John F. Coverdale, *Text As Limit: A Plea For A Decent Respect For The Tax Code*, 71 Tul. L. Rev. 1501, 1507 (May 1997) ("A decision rule that prohibits courts from adopting antitextual interpretations reflects the proper role of the legislature and the courts under our democratic constitutional system, it respects the distinctive characteristics of the Code, and it promotes the values of certainty and predictability that are very important when dealing with tax

statutes."). Moreover, as a legal scholar cited by the Government, observed:

> The economic substance test is dizzyingly complex. . . . This complexity arises from a number of interrelated factors. First, the test is best seen as a technique of statutory interpretation, which poses open-ended and unanswerable questions. Second, the test must be applied to a near-infinite variety of economic activities and transactions. Third, the present treatment of capital is inconsistent and to some extent incoherent. Taxpayers can exploit this incoherence by structuring transactions that produce tax benefits out of thin air. And conflicting rules make it difficult, sometimes, to determine the "correct" treatment of a particular transaction. Finally, only a few cases have been decided under the economic substance test, leaving open multiple interpretations of the doctrine.

Joseph Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 29 (2000-01); *see* Gov't Post-Trial Memorandum at 38, 40 (citing Bankman). This candid assessment of the deficiencies of "economic substance" doctrine certainly does not suggest a compelling case for the court to jump into to "fill in some of the lacunae and resolve some of the [doctrine's] ambiguities." Bankman, 74 S. Cal. L. Rev. at 29. Instead, as Professor Bankman advises, "Congress may have no choice but to engage in substantive law reform. Some shelter activity will take place under even the most utopian tax structure. However, the current tax treatment of capital needlessly multiplies shelter opportunities and provides a fertile breeding ground for shelter development." *Id.* at 29-30. The court agrees.

After Professor Bankman's article was published, Congress debated several proposals to codify the "economic substance" doctrine and declined to do so. *See, e.g.*, CARE Act. S. 476, 108th Cong. § 701 (2003); Jobs and Growth Tax Relief

Reconciliation Act, S. 1054, 108th Cong. § 301 (2003); Abusive Tax Shelter Shut Down and Taxpayer Accountability Act, H.R. 1555, 108th Cong. § 101 (2003). In fact, a few days ago Congress passed a major federal tax bill, but again declined to codify the "economic substance doctrine." *See* American Jobs Creation Act of 2004, H.R. 4520, 108th Cong. (2004).

Under our time-tested system of separation of powers, it is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare. *See, e.g., Gitlitz v. Commissioner*, 531 U.S. 206, 220, 121 S.Ct. 701, 148 L.Ed.2d 613 (2001) ("Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address . . . policy concern[s]."); *United States v. Byrum*, 408 U.S. 125, 135, 92 S.Ct. 2382, 33 L.Ed.2d 238 (1972) ("When a principle of taxation requires reexamination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules[.]"); *see also American Trucking Ass'ns v. Smith*, 496 U.S. 167, 201, 110 S.Ct. 2323, 110 L.Ed.2d 148 (1990) (Scalia, J., concurring) (reminding the judiciary that their role "is to say what the law is, not to prescribe what it shall be."). Accordingly, the court has determined that where a taxpayer has satisfied all statutory requirements established by Congress, as Coltec did in this case, the use of the "economic substance" doctrine to trump "mere compliance with the Code" would violate the separation of powers.

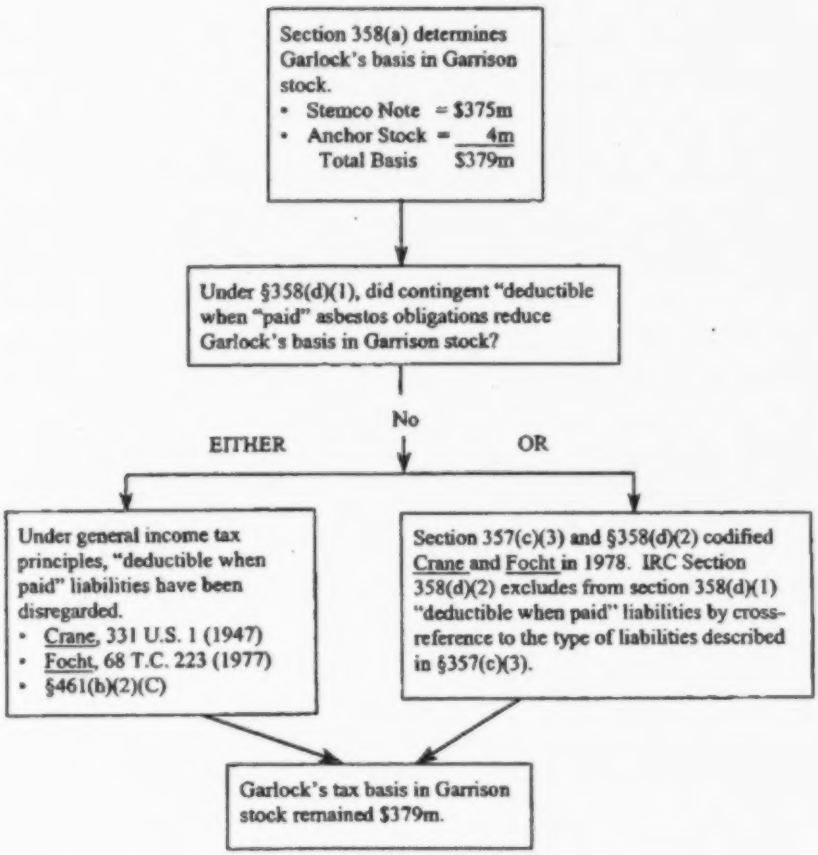
CONCLUSION

For the aforesaid reasons, the court holds that the Coltec Group is entitled to a refund of $82,803,049 for the federal tax year ending on December 31, 1996.

IT IS SO ORDERED.

Appendix A (Coltec Flowchart)

Basic Computation Flow Chart



Notes to Basis Computation Flow Chart

1. Garlock's basis was determined by § *358.* Under § *358(a)(1),* Garlock's basis is (a) its basis in the property it exchanged for the stock (the Stemco Note and the stock of Anchor), subject to (b) possible specified decreases or increases.

2. There is no dispute as to Garlock's basis in the property it exchanged. It was $379,206,091, consisting of (a) the basis of the Stemco Note, $375 million (stipulated by

the government), and (b) the basis of the Anchor stock, $4,206,091 (never disputed by the government).

3. The dispute, rather, is whether or not the assumption of the contingent liabilities by Garrison reduced Garlock's basis.

The possible reductions to basis are specified in § 358(a)(1)(A). That provision does *not* list an assumption of liabilities. It does, however, list "money received by the taxpayer [Garlock]."

4. The rules regarding liability assumptions are set out in § *358(d)*.

Section 358(d)(1) sets out the general rule: an assumption of a liability of the taxpayer shall for purposes of § 358 be treated as "money received by the taxpayer" (which would reduce basis).

5. However, *contingent* ("deductible when paid") liabilities are not liabilities for purposes of §§ 357 or 358. *See* Plaintiff's Pre-Trial Brief at 14-16; Plaintiff's Post-Trial Brief at 3-6; Oral Argument, Tr. 228:22-230:10. *See also*, Kahn and Oesterle, *A Definition of Liabilities,* 73 Michigan Law Review Vol. 73, 461 at 470 (1975). Legislative history demonstrates that the exclusion of the assumption of deductible liabilities under the *Crane* doctrine was incorporated into Section 357 and 358: The term "liabilities" in those sections refers only to obligations the transfer of which would cause realization of income to the transferor under *Crane.*" Thus, § 358(d)(1) was inapplicable, and the assumption of the contingent liabilities did not reduce Garlock's basis in the stock.

6. Further, *even if* the contingent liabilities were liabilities within the meaning of §§ 357 and 358, § 358(d)(1) would remain inapplicable.

That is because § *358(d)(2)* sets out an exception to (d)(1): § 358(d)(1) "shall *not* apply" to the amount of any liability "excluded under *section 357(c)(3).*" Emphasis added.

7. Section 357(c)(3) provides in relevant part that the amount of "a liability the payment of which . . . would give rise to a deduction . . . *shall be excluded* in determining the amount of liabilities assumed . . . ." Emphasis added.

There is no dispute that "the payment" of the asbestos liabilities "would give rise to a deduction."

8. As a result, § 358(d)(1) was not applicable for that reason as well, and the assumption of the contingent liabilities did not reduce Garlock's basis in the stock.

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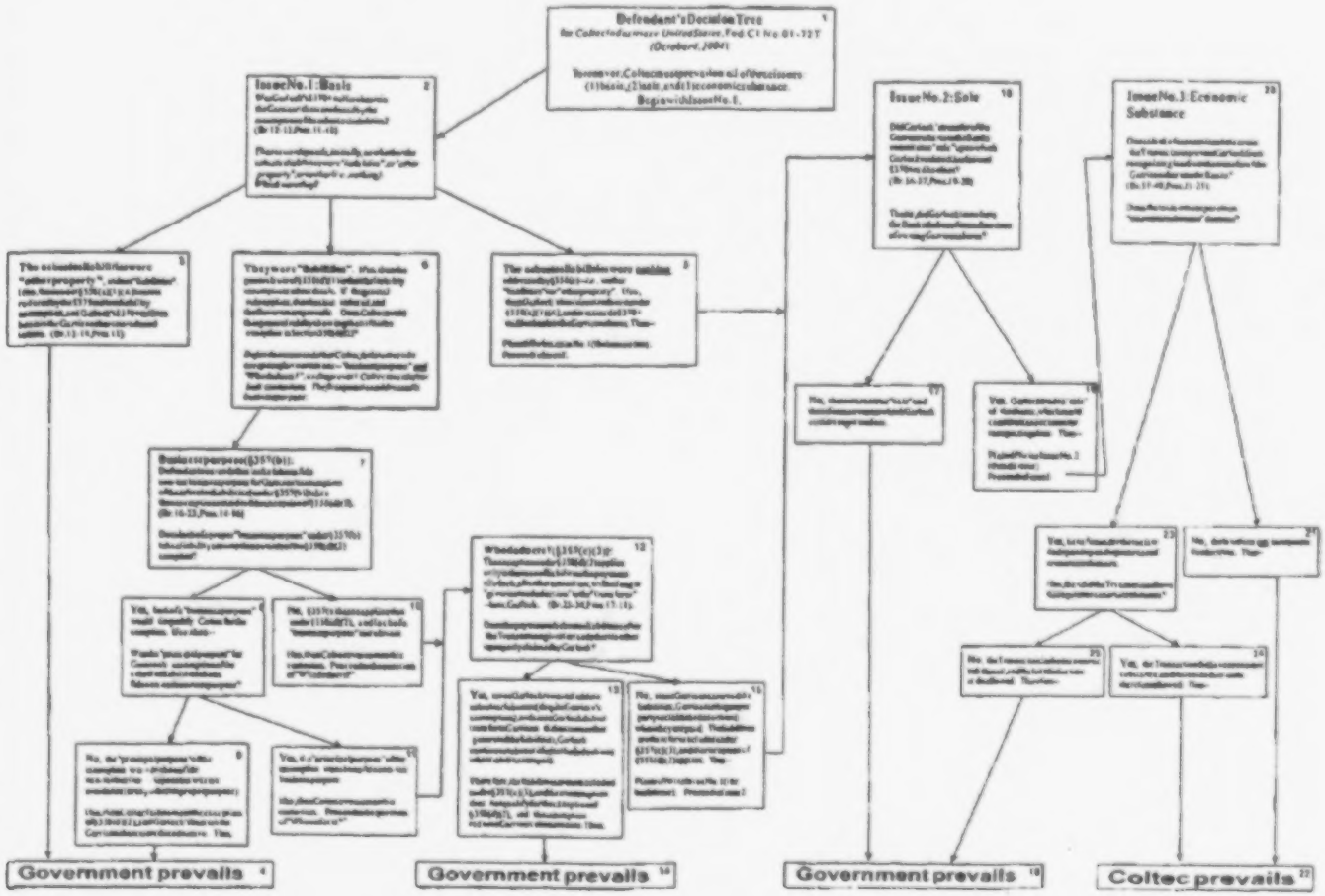
Appendix B (Government Flowchart)



APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

[Filed SEP 19, 2006]

05-5111

COLTEC INDUSTRIES, INC.,
Plaintiff-Appellee,

v.

UNITED STATES,
Defendant-Appellant.

NOTE: Pursuant to Fed. Cir. R. 47.6, this order is not citable as precedent. It is a public order.

ORDER

Before Bryson, Circuit Judge, Gajarsa, Circuit Judge, and Dyk, Circuit Judge.

A petition for rehearing having been filed by the Appellee,

UPON CONSIDERATION THEREOF, it is

ORDERED that the petition for rehearing be, and the same hereby is, DENIED.

The mandate of the court will issue on September 26, 2006.

FOR THE COURT,

/s/ Jan Horbaly
Jan Horbaly

Dated: 09/19/2006

cc: Judith A. Hagley
Stephen D. Gardner

APPENDIX D

FEDERAL STATUTES

26 U.S.C. § 351 (1996). Transfer to corporation controlled by transferor

(a) General rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

(b) Receipt of property.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

* * * *

(g) Cross references.—

(1) For special rule where another party to the exchange assumes a liability, or acquires property subject to a liability, see section 357.

(2) For the basis of stock or property received in an exchange to which this section applies, see sections 358 and 362.

* * * *

26 U.S.C. § 357 (1996). Assumption of liability

(a) General rule.—Except as provided in subsections (b) and (c), if—

(1) the taxpayer receives property which would be permitted to be received under section 351 or 361 without the recognition of gain if it were the sole consideration, and

(2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability,

then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351 or 361, as the case may be.

(b) Tax avoidance purpose.—

(1) In general.—If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—

(A) was a purpose to avoid Federal income tax on the exchange, or

(B) if not such purpose, was not a bona fide business purpose,

then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351 or 361 (as the case may be), be considered as money received by the taxpayer on the exchange.

(2) Burden of proof.—In any suit or proceeding where the burden is on the taxpayer to prove such assumption or acquisition is not to be treated as money received by

the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

(c) Liabilities in excess of basis.—

(1) In general.—In the case of an exchange—

(A) to which section 351 applies, or

(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D),

if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(2) Exceptions.—Paragraph (1) shall not apply to any exchange—

(A) to which subsection (b)(1) of this section applies, or

(B) which is pursuant to a plan of reorganization within the meaning of section 368(a)(1)(G) where no former shareholder of the transferor corporation receives any consideration for his stock.

(3) Certain liabilities excluded.—

(A) In general.—If a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which either—

(i) would give rise to a deduction, or

(ii) would be described in section 736(a),

then, for purposes of paragraph (1), the amount of such liability shall be excluded in determining the amount of liabilities assumed or to which the property transferred is subject.

(B) Exception.—Subparagraph (A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property.

26 U.S.C. § 358 (1996). Basis to distributees

(a) General rule.—In the case of an exchange to which section 351, 354, 355, 356, or 361 applies—

(1) Nonrecognition property.—The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—

(A) decreased by—

(i) the fair market value of any other property (except money) received by the taxpayer,

(ii) the amount of any money received by the taxpayer, and

(iii) the amount of loss to the taxpayer which was recognized on such exchange, and

(B) increased by—

(i) the amount which was treated as a dividend, and

(ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

(2) Other property.—The basis of any other property (except money) received by the taxpayer shall be its fair market value.

* * * *

(d) Assumption of liability.—

(1) In general.—Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

(2) Exception.—Paragraph (1) shall not apply to the amount of any liability excluded under section 357(c)(3).

* * * *

No. 06-659

In the Supreme Court of the United States

COLTEC INDUSTRIES, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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Washington, D.C. 20530-0001
(202) 514-2217

QUESTIONS PRESENTED

1. Whether the court of appeals applied the correct standard of review in determining that petitioner's underlying transaction lacked economic substance (and that petitioner was therefore not entitled to claim a capital-loss tax deduction related to that transaction).

2. Whether the court of appeals applied the correct substantive standard in determining that petitioner's transaction lacked economic substance.

TABLE OF CONTENTS

Page

Opinions below 1
Jurisdiction 1
Statement 1
Argument 9
Conclusion 21

TABLE OF AUTHORITIES

Cases:

ACM P'ship v. *Commissioner*, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999) 12, 16
American Realty Trust v. *United States*, 498 F.2d 1194 (4th Cir. 1974) 11
ASA Investerings P'ship v. *Commissioner*, 201 F.3d 505 (D.C. Cir.), cert. denied, 531 U.S. 871 (2000) 12, 19
Bazley v. *Commissioner*, 331 U.S. 737 (1947) 11
Black & Decker Corp. v. *United States*, 436 F.3d 431 (4th Cir. 2006) 10, 19
Commissioner v. *Court Holding Co.*, 324 U.S. 331 (1945) 11
Frank Lyon Co. v. *United States*, 435 U.S. 561 (1978) 11, 15
Gregory v. *Helvering*, 293 U.S. 465 (1935) 4, 15
Horn v. *Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992) 17, 18
Knetsch v. *United States*, 364 U.S. 361 (1960) 4
Nicole Rose Corp. v. *Commissioner*, 320 F.3d 282 (2d Cir. 2002) 12

Cases—Continued: Page

Ornelas v. *United States*, 517 U.S. 690 (1996) 11
Rice's Toyota World, Inc. v. *Commissioner*, 752 F.2d 89 (4th Cir. 1992) 12, 17, 18
Rose v. *Commissioner*, 868 F.2d 851 (6th Cir. 1989) 16
Salve Regina Coll. v. *Russell*, 499 U.S. 225 (1991) 11
Sochin v. *Commissioner*, 843 F.2d 351 (9th Cir.), cert. denied, 488 U.S. 824 (1988) 16
Yosha v. *Commissioner*, 861 F.2d 494 (7th Cir. 1988) ... 12

Statutes:

26 U.S.C. 357(b)(1) (1994) 5, 6
26 U.S.C. 357(c)(3) (1994) 5, 6
26 U.S.C. 358 (1994) 4
26 U.S.C. 358(d)(1) (1994) 5, 6
26 U.S.C. 358(d)(2) (1994) 5, 6
26 U.S.C. 358(h) (2000 & Supp. III 2003) 20

In the Supreme Court of the United States

No. 06-659

COLTEC INDUSTRIES, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-33a) is reported at 454 F.3d 1340. The opinion of the Court of Federal Claims (Pet. App. 34a-123a) is reported at 62 Fed. Cl. 716.

JURISDICTION

The judgment of the court of appeals was entered on July 12, 2006. A petition for rehearing was denied on September 19, 2006 (Pet. App. 124a). The petition for a writ of certiorari was filed on November 8, 2006. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. In 1996, petitioner, a diversified manufacturing company, decided to sell one of its subsidiaries. Peti-

tioner expected to generate a taxable capital gain of over $240 million from the sale. In an effort to reduce or eliminate its tax liability resulting from that gain, petitioner contacted its tax adviser, the now-defunct accounting firm Arthur Andersen. To that end, Arthur Andersen proposed that petitioner use a tax-planning scheme that it had been marketing to other corporate clients with sizable contingent liabilities. Petitioner had such contingent liabilities because one of its subsidiaries, Garlock (and its subsidiary, Anchor Packing Company), had previously manufactured and distributed asbestos products. Pet. App. 2a-3a; C.A. App. 703, 2282, 2540-2546, 7200-7201.

Although Arthur Andersen's tax-planning scheme was complex, the ultimate goal was simple: namely, to allow the taxpayer to circumvent the prohibition on immediate deductions for contingent liabilities by converting those liabilities into an artificial capital loss. The tax-planning scheme involved three steps. First, the parent company would reorganize a dormant subsidiary corporation into a special-purpose entity. Second, the parent company would transfer property and contingent liabilities to the newly reorganized subsidiary in exchange for stock. Third, the parent company would sell the stock to a third party for its (nominal) fair market value. For tax purposes, the parent company would use the value of the transferred property as the tax basis for the sale, without taking into account the amount of the contingent liabilities, under the basis rules applicable to intracorporate tax-free transfers. As a result, the parent company would accrue a significant capital loss from the sale of the stock, because the tax basis for the sale would be considerably higher than the amount received. The resulting capital loss could then be used to offset

any capital gain realized by the taxpayer during the relevant tax year. Pet. App. 2a-3a, 5a.

Petitioner decided to implement Arthur Andersen's tax-planning scheme. First, petitioner selected a dormant subsidiary corporation, renamed it Garrison Litigation Management Group, and reorganized it into a special-purpose entity. Second, petitioner transferred property to Garrison in exchange for stock and Garrison's agreement to pay Garlock's contingent liabilities. Specifically, petitioner caused one of Garlock's other subsidiaries, Stemco, to issue a $375 million promissory note to Garlock, and then caused Garlock to issue an offsetting $314 million promissory note in return to Stemco. Petitioner then transferred the $375 million promissory note from Garlock to Garrison, in return for Garrison's assuming Garlock's asbestos-related liabilities (which had been estimated for purposes of the tax shelter, using generous assumptions, at $375 million). Garrison issued 100,000 shares of common stock to Garlock—the shares that would ultimately give rise to Coltec's claimed capital loss. (Garrison also issued a controlling block of shares to petitioner.) Third, Garlock sold the 100,000 shares of Garrison stock to two banks, in return for $500,000. As part of that sale, petitioner agreed to indemnify the banks against any asbestos-related claims. Pet. App. 3a-5a & n.2, 53a, 57a.

On its income tax return for 1996, petitioner claimed that Garlock's basis in the Garrison stock was $379.2 million (representing the $375 million Stemco note and $4.2 million in other property contributed by Garlock to Garrison). Petitioner did not reduce this basis by the $375 million in contingent liabilities assumed by Garrison. Because Garlock sold the stock for only $500,000, it claimed a capital loss on the transaction of $378.7 mil-

lion. That loss more than offset petitioner's gains for that tax year; in fact, petitioner carried over the unused portion of the loss to offset gains in future years. Petitioner recognized that loss only for tax purposes; the loss was not reported on petitioner's public financial statements, although a loss of that size would plainly have been material. Pet. App. 5a.

2. The Internal Revenue Service (IRS) disallowed the claimed loss and assessed tax deficiencies totaling more than $82 million. Pet. App. 6a. The loss was disallowed on two grounds. First, the IRS determined that petitioner had erroneously excluded the amount of the contingent liabilities from the basis for the stock under the statutory provisions governing the calculation of basis in intracorporate tax-free transfers. See 26 U.S.C. 358.[1] Second, and more relevant here, the IRS determined that, even if petitioner had correctly calculated the basis for the stock under those provisions, petitioner was not entitled to claim a loss under the economic-substance doctrine. That doctrine provides that a claimed tax deduction may be disallowed if the underlying transaction lacks economic substance, *i.e.*, if "there was nothing of substance to be realized by [the taxpayer] from th[e] transaction beyond a tax deduction." *Knetsch* v. *United States*, 364 U.S. 361, 366 (1960); see *Gregory* v. *Helvering*, 293 U.S. 465, 469-470 (1935).

3. After paying the assessed amount, petitioner filed a refund suit in the Court of Federal Claims. After a bench trial, the court entered judgment in favor of petitioner. Pet. App. 34a-123a. With regard to the government's statutory arguments, the court first held that the

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[1] Unless otherwise noted, all references in this brief to the relevant statutory provisions are to the 1994 edition of the United States Code.

contingent liabilities were subject to exclusion from petitioner's basis because they did not even constitute "liabilities" under 26 U.S.C. 358(d)(1). Pet. App. 77a-78a. In the alternative, the court held that the contingent liabilities were subject to exclusion under 26 U.S.C. 358(d)(2), because they would "give rise to a deduction" under an incorporated statutory provision, 26 U.S.C. 357(c)(3). Pet. App. 91a-93a. The court also held that the transaction did not trigger a statutory anti-abuse provision, 26 U.S.C. 357(b)(1), because "the principal purpose of [petitioner] entering into the Garrison transaction was not solely to avoid federal income tax," Pet. App. 84a-85a, and because "Garrison's assumption of Garlock's contingent asbestos liabilities had a '*bona fide*' business purpose." *Id.* at 91a.

The Court of Federal Claims also rejected the government's argument that the loss should be disallowed because the relevant underlying transaction lacked economic substance. Pet. App. 109a-119a. The court concluded that, "where a taxpayer has satisfied all statutory requirements established by Congress, * * * the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers." *Id.* at 119a. And the court added that, even assuming that the economic-substance doctrine were applicable, it would conclude that petitioner's transaction had economic substance, based on its determination that "[petitioner] satisfied the tax avoidance and business purpose tests in" the statutory anti-abuse provision, 26 U.S.C. 357(b)(1). Pet. App. 115a.

4. The court of appeals vacated and remanded. Pet. App. 1a-33a.

a. The court of appeals, like the trial court, ultimately concluded that petitioner's claimed capital loss

"falls within the literal terms of the statute." Pet. App. 17a. The court of appeals did reject the trial court's conclusion that contingent liabilities did not even constitute "liabilities" under 26 U.S.C. 358(d)(1), reasoning that "[i]t is widely recognized that when one party in an exchange assumes a contingent liability of another party, that contingent liability, like all other liabilities, forms an integral part of the purchase price in the exchange." Pet. App. 9a. But the court of appeals agreed with the trial court that the contingent liabilities were nevertheless subject to exclusion from petitioner's basis under 26 U.S.C. 358(d)(2), because they would "give rise to a deduction" under an incorporated statutory provision, 26 U.S.C. 357(c)(3). Pet. App. 12a-13a. Finally, while the court of appeals also agreed with the trial court that the transaction was not subject to the statutory anti-abuse provision, 26 U.S.C. 357(b)(1), it reached that conclusion on a different ground: namely, that, while the relevant provisions "are not a model of statutory draftsmanship," Section 357(b)(1) was inapplicable because it was not incorporated into Section 358(d)(2), the statutory provision governing exclusions from basis in intracorporate tax-free transfers. Pet. App. 14a-17a.

b. Unlike the trial court, however, the court of appeals held that the relevant underlying transaction lacked economic substance. Pet. App. 17a-33a. The court of appeals first rejected as "untenable" the trial court's holding that the economic-substance doctrine violated the separation of powers. *Id.* at 17a. The court of appeals explained that, "[o]ver the last seventy years, the economic substance doctrine has required disregarding, for tax purposes, transactions that comply with the literal terms of the tax code but lack economic reality." *Id.* at 18a. The court of appeals reasoned that, "[i]n re-

jecting the economic substance doctrine, the [trial] court failed to follow binding precedent of the Supreme Court and this court and its predecessor court, the Court of Claims." *Id.* at 17a. "Even if we were to assume that the decisions of the Supreme Court and our predecessor court recognizing the economic substance doctrine are not binding," the court of appeals continued, "we cannot agree that the doctrine is somehow unconstitutional." *Id.* at 20a. The court reasoned that "[t]he economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code." *Id.* at 21a. "In this regard," the court added, "the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute." *Ibid.*

The court of appeals then considered, and rejected, the trial court's alternative holding that the underlying transaction had economic substance in any event. Pet. App. 23a-33a. The court of appeals explained that, "[w]hile the [economic-substance] doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance." *Id.* at 24a (footnote omitted). The court stated that "the economic substance of a transaction must be viewed objectively rather than subjectively." *Id.* at 25a. And the court noted that, in applying the economic-substance doctrine, "the transaction to be analyzed is the one that gave rise to the alleged tax benefit," *id.* at 26a, and that "arrangements with subsidiaries that do not affect the economic interest

of independent third parties deserve particularly close scrutiny," *id.* at 27a.

Having stated those general principles, the court of appeals determined that the relevant underlying transaction lacked economic substance. Pet. App. 28a-33a. At the outset, the court noted that "[t]he ultimate conclusion as to business purpose is a legal conclusion, which we review without deference." *Id.* at 28a. At the same time, the court observed that "the underlying relevant facts are in large part undisputed." *Ibid.*

The court of appeals proceeded to determine that the trial court had erred in two respects. First, the court of appeals noted that the trial court had determined that the creation of Garrison to manage petitioner's asbestos liabilities served a *bona fide* business purpose. Pet. App. 29a. The court of appeals explained, however, that the trial court erred by focusing on the wrong transaction, because the transfer of management activities was not "the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale." *Ibid.* Instead, the court of appeals reasoned, the relevant transaction was "Garrison's assumption of Garlock's asbestos liabilities in exchange for the $375 million note." *Ibid.* The court concluded that, as to that transaction, "[petitioner] has not demonstrated any business purpose to be served by linking Garrison's assumption of the liabilities to the centralization of litigation management." *Id.* at 29a-30a (footnote omitted).

Second, the court of appeals noted that the trial court had determined that the overall transaction was designed to strengthen petitioner's position against potential veil-piercing claims. Pet. App. 30a. While recognizing that petitioner's executives had testified about the veil-piercing benefits that they allegedly perceived from

the transaction, *id.* at 31a, the court of appeals concluded that "[the] subjective views of [petitioner's] executives, even if credited, * * * are insufficient to establish economic substance." *Ibid.* Instead, the court reasoned, "there is no basis in reality for the idea that a corporation can avoid exposure for past acts by transferring liabilities to a subsidiary." *Id.* at 32a. The court explained that "the transaction here could only affect relations among [petitioner] and its own subsidiaries—it has absolutely no effect on third party asbestos claimants." *Ibid.*

Having noted those two errors, the court of appeals stated that it "s[aw] nothing indicating that the transfer of liabilities in exchange for the note effected any real change in the 'flow of economic benefits,' provided any real 'opportunity to make a profit,' or 'appreciably affected' [petitioner's] beneficial interests aside from creating a tax advantage." Pet. App. 33a. Because "Garrison's assumption of Garlock's liabilities in exchange for the Stemco note served no purpose other than to artificially inflate Garlock's basis in its Garrison stock," the court concluded, "[t]hat transaction must be disregarded for tax purposes." *Ibid.*

5. Petitioner filed a petition for panel rehearing, which the court of appeals denied without recorded dissent. Pet. App. 124a.

ARGUMENT

Petitioner contends (Pet. 14-17) that the court of appeals erred by applying *de novo* review to the district court's ultimate determination that its transaction had economic substance, and also contends (Pet. 18-28) that the court of appeals erred by focusing solely on whether its transaction lacked economic substance as an objec-

tive matter and not on whether petitioner had a non-tax business purpose for engaging in the transaction. The court of appeals' decision is correct, and further review is not warranted on either issue.

1. As a preliminary matter, petitioner does not contend that the court of appeals' ultimate holding—*i.e.*, that petitioner's underlying transaction lacked economic substance—directly conflicts with the holding of any other court of appeals. Nor could it, because the only other court of appeals to have considered a similar tax shelter also reversed the trial court's determination that the transaction at issue had economic substance (and, in that case, remanded for further proceedings). See *Black & Decker Corp.* v. *United States*, 436 F.3d 431, 440-443 (4th Cir. 2006).

2. Instead, petitioner contends (Pet. 14-17) that the court of appeals erred by applying *de novo* review to the district court's ultimate determination that its transaction had economic substance.[2] That claim does not warrant further review.

a. In this case, after noting that "the underlying relevant facts are in large part undisputed," the court of appeals explained that a trial court's "ultimate conclusion" as to whether a transaction had economic substance is reviewed "without deference." Pet. App. 28a. That description of the applicable standard of review is correct. As this Court explained in holding that a transaction involving a sale-leaseback arrangement had economic substance, "[t]he general characterization of a transaction for tax purposes is a question of law subject to review," whereas "[t]he particular facts from which

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[2] The same question is presented in *Dow Chemical Co.* v. *United States*, petition for cert. pending, No. 06-478 (filed Oct. 4, 2006).

the characterization is to be made are not so subject." *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 581 n.16 (1978).[3] That standard of review, moreover, is consistent with the standard of review applicable to similar "mixed" questions of law and fact. See, *e.g.*, *Ornelas* v. *United States*, 517 U.S. 690, 696-697 (1996) (applying *de novo* review to "ultimate determinations of reasonable suspicion and probable cause," while recognizing that clear-error review applies to the "determination of historical facts" underlying that ultimate determination); cf. *Salve Regina Coll.* v. *Russell*, 499 U.S. 225, 233

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[3] Petitioner contends (Pet. 17) that, in *Frank Lyon*, this Court distinguished between "how transactions are characterized under the tax code" and "factual findings of economic substance." However, the fairer reading of the language quoted above—and the other cases on which petitioner relies (Pet. 16)—is that the Court was distinguishing between an *ultimate* determination that a transaction has (or lacks) economic substance and *subsidiary* determinations on historical facts. Cf. *Bazley* v. *Commissioner*, 331 U.S. 737, 743 (1947) (concluding that the lower courts were operating under "no misconception of law" and that "the facts as found by the Tax Court bring them within [the applicable legal rule]"); *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 333-334 (1945) (stating that "the findings of the Tax Court * * * must * * * be accepted by the [appellate] courts" and that an appellate court was not free to "draw[] different inferences from the record"). The distinction that petitioner posits would be entirely illusory, because how a transaction is characterized under the Internal Revenue Code will often turn on whether the underlying transaction had economic substance. In *Frank Lyon*, the Court made the statement quoted above in the course of rejecting the government's contention that the taxpayer, although the nominal owner of the property purchased from and leased back to the bank, was not in substance the true owner entitled to take depreciation deductions. 435 U.S. at 581. Moreover, the Court cited as authority for its statement of the standard of review a Fourth Circuit decision that similarly involved the economic-substance doctrine. See *id.* at 581 n.16 (citing *American Realty Trust* v. *United States*, 498 F.2d 1194, 1198 (4th Cir. 1974)).

(1991) (noting that more deferential review of "mixed" questions is warranted only where "the district court is better positioned than the appellate court to decide the issue in question or * * * probing appellate scrutiny will not contribute to the clarity of legal doctrine") (internal quotation marks omitted).

As petitioner correctly notes (Pet. 14), several courts of appeals have stated that a district court's determination as to whether a transaction had economic substance was reviewable only for clear error. See, *e.g.*, *Nicole Rose Corp.* v. *Commissioner*, 320 F.3d 282, 284 (2d Cir. 2002); *ASA Investerings P'ship* v. *Commissioner*, 201 F.3d 505, 511 (D.C. Cir.), cert. denied, 531 U.S. 871 (2000); *ACM P'ship* v. *Commissioner*, 157 F.3d 231, 245 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); *Yosha* v. *Commissioner*, 861 F.2d 494, 499 (7th Cir. 1988); *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89, 92 (4th Cir. 1985). Those decisions, however, contain minimal analysis—and, with regard to at least some of those decisions, it is unclear whether the courts were deferring to the ultimate determination on economic substance, or merely to underlying factual determinations that may have been dispositive of that ultimate determination. Moreover, to the extent that those courts did hold that a district court's ultimate determination on economic substance was reviewable only for clear error, those decisions cannot be reconciled with this Court's statement of the applicable standard of review in *Frank Lyon*.

b. In any event, this case does not provide the Court with a suitable opportunity to revisit any question concerning the standard of review applicable to a district court's ultimate determination on economic substance, because petitioner did not preserve any argument that

such a determination should be subject to deferential review. In the court of appeals, petitioner argued, at most, that the trial court's *underlying* factual findings were reviewable only for clear error—and never suggested that the trial court's *ultimate* determination was also subject to clear-error review. See, *e.g.*, Pet. C.A. Br. 33 n.18 (generically stating that "[t]he [Court of Federal Claims'] factual determinations may be disturbed only if they were clearly erroneous"); cf. *id.* at 32 n.17 (criticizing the government for "assert[ing] that the CFC made a legal error" instead of "directly disputing the CFC's findings of fact"). Accordingly, it is unsurprising that the court of appeals, without extended discussion, stated that a trial court's "ultimate conclusion" on economic substance should be reviewed "without deference." Pet. App. 28a.[4]

This case would constitute a poor vehicle for considering the standard-of-review question now raised by petitioner for another reason. In vacating the decision of the Court of Federal Claims, the court of appeals did not overturn any of that court's factual findings, but instead held (1) that the trial court erred by focusing on the wrong transaction, see Pet. App. 28a-30a, and (2) that the trial court erred by concluding that the transaction at issue could have strengthened petitioner's position against potential veil-piercing claims, see *id.* at 30a-33a. Although petitioner contends (Pet. 23-28) that the trial court did not err in either respect, petitioner

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[4] Moreover, petitioner did not seek rehearing (either by the panel or by the en banc Federal Circuit) on the standard-of-review issue. Instead, in its petition for panel rehearing, petitioner merely challenged various facets of the court of appeals' substantive holding that the transaction lacked economic substance. See, *e.g.*, Pet. for Panel Reh'g 1-2 (listing issues presented).

does not dispute that each of those errors was legal, rather than factual, in nature. Petitioner does not explain how the clear-error standard of review could meaningfully be applied to the trial court's resolution of those subsidiary legal issues. *A fortiori*, it would have been incongruous for the court of appeals to have engaged in clear-error review of the trial court's *ultimate* determination that the transactions at issue had economic substance, when that determination rested on the trial court's (erroneous) resolution of those subsidiary legal questions. Because the court of appeals did not pass on *any* subsidiary factual issues in reversing the trial court's ultimate determination on economic substance—and indeed recognized that "the underlying relevant facts are in large part undisputed," Pet. App. 28a—this case is an exceptionally weak candidate for application of a deferential standard of review.

3. Petitioner also contends (Pet. 18-28) that the court of appeals erred by focusing solely on whether its transaction lacked economic substance as an objective matter and not on whether petitioner had a non-tax business purpose in engaging in the transaction. While the courts of appeals have articulated the substantive standard for determining whether a taxpayer's transactions had economic substance in somewhat different ways, they have applied that standard consistently, and the court of appeals in this case articulated that standard correctly. Further review is therefore not warranted at this time.

a. The court of appeals held in this case that "the economic substance of a transaction must be viewed objectively rather than subjectively," Pet. App. 25a, and added that, "[w]hile the [economic-substance] doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has eco-

nomic substance, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance." *Id.* at 24a (footnote omitted). That statement of the applicable standard is correct. As the court of appeals noted, this Court's cases "have repeatedly looked to the objective economic reality of the transaction in applying the economic substance doctrine." *Id.* at 25a; see, *e.g.*, *Frank Lyon*, 435 U.S. at 573 (noting that "the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed"); *Gregory* v. *Helvering*, 293 U.S. 465, 469-470 (1935) (stating that "the question for determination is whether what was done, *apart from the tax motive*, was the thing which the statute intended," and concluding that "[t]he rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute") (emphasis added).

Petitioner contends (Pet. 20) that the court of appeals adopted a "disjunctive" standard and thereby held that a transaction could lack economic substance *either* if it lacked economic substance as an objective matter *or* if the taxpayer lacked a non-tax business purpose in engaging in the transaction. It is clear from the language quoted above, however, that the court of appeals did not address the question whether the economic-substance doctrine could apply solely on the basis that the taxpayer lacked a non-tax business purpose for the transaction, where the transaction had economic substance as an objective matter. Because the court of appeals left open that question, the decision below does not conflict with the decisions of other courts of appeals framing the

standard in "disjunctive" terms—and petitioner does not so contend. See Pet. 20-21.[5]

b. Petitioner seemingly suggests (Pet. 21-22) that the court of appeals' decision conflicts with the decisions of various courts of appeals applying a "unitary" standard, under which courts have considered a taxpayer's intent as "inform[ing] the analysis of whether the transaction had sufficient substance * * * to be respected for tax purposes." *ACM P'ship*, 157 F.3d at 247; see, *e.g.*, *Rose* v. *Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989) (stating that "[a] taxpayer's subjective business purpose * * * may be relevant to [the economic-substance] inquiry"); *Sochin* v. *Commissioner*, 843 F.2d 351, 354 (9th Cir.) (noting that "consideration of business purpose" was "simply [a] more precise factor[] to consider in the application of this court's traditional sham analysis"), cert. denied, 488 U.S. 824 (1988). The court of appeals in this case, however, did not hold that a taxpayer's intent was *irrelevant* to the economic-substance inquiry. As petitioner at one point concedes (Pet. 18), the better reading of the court of appeals' decision is that it viewed proof that the taxpayer had a non-tax business purpose for the transaction—as a "pertinent" factor in that inquiry: *i.e.*, as probative, but not dispositive, evidence that the transaction had economic substance as an objective matter. Pet. App. 23a; cf. *id.* at 31a-32a (noting that "[the] subjective views of [petitioner's] executives [with regard to veil-piercing benefits] * * * are insufficient to establish economic substance" where "there is no basis in reality" to support

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[5] Petitioner does not identify any case in which a court of appeals has actually held that a transaction lacked economic substance *solely* on the ground that the taxpayer lacked a non-tax business purpose in engaging in the transaction.

the existence of those benefits). Moreover, as petitioner also conce (Pet. 23), even if the court of appeals' decision were d as discounting a taxpayer's intent altogether, it is at best questionable whether petitioner would prevail in this case if the existence of a non-tax business purpose were merely relevant to, but not dispositive of, the economic-substance inquiry. The court of appeals' decision therefore does not conflict with decisions applying a "unitary" standard.

c. Petitioner's primary contention (Pet. 19-20) is that the court of appeals' decision conflicts with decisions of the Fourth and District of Columbia Circuits applying a "conjunctive" standard, under which a transaction could lack economic substance only if it lacked economic substance as an objective matter *and* if the taxpayer lacked a non-tax business purpose in engaging in the transaction. Petitioner suggests (Pet. 23) that, if that standard were applied in this case, petitioner would prevail, based on the trial court's findings that "the principal purpose of [petitioner] entering into the Garrison transaction was not solely to avoid federal income tax," Pet. App. 84a-85a, and that "Garrison's assumption of Garlock's contingent asbestos liabilities had a '*bona fide*' business purpose." *Id.* at 91a.

As petitioner notes (Pet. 19), the Fourth and District of Columbia Circuits have articulated the substantive standard for determining whether a taxpayer's transactions had economic substance in "conjunctive" terms. See, *e.g.*, *Horn* v. *Commissioner*, 968 F.2d 1229, 1237 (D.C. Cir. 1992) (stating that "a transaction undertaken for a nontax business purpose will not be considered an economic sham *even if* there was no objectively reasonable possibility that the transaction would produce profits"); *Rice's Toyota World*, 752 F.2d at 91 (providing

that, "[t]o treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits * * * and that the transaction has no economic substance because no reasonable possibility of a profit exists"). The court of appeals in this case, moreover, expressly rejected the Fourth Circuit's formulation of the standard, on the ground that it was "not consistent with the Supreme Court's pronouncements in cases such as *Frank Lyon*." Pet. App. 24a n.14.

Any divergence between the court of appeals' formulation and those of the Fourth and District of Columbia Circuits, however, does not warrant further review at this time, because petitioner identifies no case in which either of those courts has actually held that a transaction had economic substance *solely* on the basis that the taxpayer had a non-tax business purpose for the transaction, even though the transaction lacked economic substance as an objective matter. See *Rice's Toyota World*, 752 F.2d at 92-95 (affirming trial court's determinations both that the transaction lacked economic substance as an objective matter and that the taxpayer had no non-tax business purpose for the transaction); cf. *Horn*, 968 F.2d at 1236, 1238 (noting trial court's determination that "the taxpayers engaged the transactions in such a way as to create the tax benefits while completely avoiding economic risk" and the parties' assumption that "no evidence has shown a nontax business purpose," but concluding that the applicable statute nevertheless expressly authorized the claimed tax benefits).

Indeed, in the wake of more recent decisions from each circuit, it is far from clear whether the "conjunctive" test articulated by those circuits differs in any meaningful way from the tests articulated by other cir-

cuits. In a case involving the same type of tax shelter at issue here, the Fourth Circuit, while reiterating its "conjunctive" formulation from *Rice's Toyota World*, explained that both prongs of its formulation were "directed to the same question: whether the transaction contained economic substance aside from the tax consequences." *Black & Decker*, 436 F.3d at 441 (citation omitted). In the same case, moreover, the Fourth Circuit made clear that "a taxpayer's mere assertion of subjective belief in the profit opportunity from a transaction[,] particularly in the face of strong objective evidence that the taxpayer would incur a loss, cannot by itself establish that the transaction was not a sham." *Id.* at 443 (internal quotation marks and citation omitted). For its part, the District of Columbia Circuit, without so much as citing its earlier formulation in *Horn*, stated in a later case that, under the economic-substance doctrine, "the absence of a nontax business purpose is fatal." *ASA Investerings P'ship*, 201 F.3d at 512. The court added that "a transaction will be disregarded if it did not *appreciably* affect [taxpayer's] beneficial interest except to reduce his tax." *Id.* at 514 (internal quotation marks and citation omitted).

As matters currently stand, therefore, it is at best uncertain whether either the Fourth Circuit or the District of Columbia Circuit would actually hold that a transaction had economic substance *solely* on the basis that the taxpayer had a non-tax business purpose for the transaction, even though the transaction lacked economic substance as an objective matter. As the court of appeals in this case suggested, such a holding would be inconsistent with this Court's decisions on the economic-substance doctrine, which have focused on whether the transaction at issue had economic substance as an objec-

tive matter. See p. 15, *supra*. And it would allow a corporation to obtain tax advantages for a transaction entirely lacking in objective economic substance simply by coming forward with testimony from its executives concerning the purported business motivations for the transaction. In the event that a court of appeals were to allow a taxpayer to avoid application of the economic-substance doctrine on that basis, a genuine conflict would then exist, and further review might be warranted. At this time, however, there is no real conflict concerning the application of the economic-substance doctrine that merits this Court's intervention.

d. Finally, even if the courts of appeals' different formulations of the economic-substance standard would otherwise provide a sufficient justification for this Court's review, this case would constitute a poor vehicle because it arises in a context of only limited prospective importance. In 2000, Congress foreclosed taxpayers from using contingent-liability tax shelters of the type at issue here by amending the basis rules applicable to intracorporate tax-free transfers to provide for the reduction of basis in cases such as this one. See 26 U.S.C. 358(h) (2000 & Supp. III 2003). We are aware of only three other currently pending cases concerning the application of the economic-substance doctrine to similar tax shelters. Particularly in light of the uncertainty concerning the existence (and extent) of a meaningful conflict, the limited prospective importance of this context counsels against further review.[6]

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[6] This case would additionally constitute a poor vehicle because, as the government argued below, petitioner's capital loss should be disallowed under the governing statutory provisions, regardless of the applicability of the economic-substance doctrine. Although the court of appeals ultimately rejected those arguments, it recognized that the

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JANUARY 2007

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relevant statutory provisions "are not a model of statutory draftsmanship." Pet. App. 15a.

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IN THE

Supreme Court of the United States

COLTEC INDUSTRIES INC.,

Petitioner,

v.

UNITED STATES,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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RULE 29.6 STATEMENT

The Rule 29.6 statement in the petition is current.

TABLE OF CONTENTS

	Page
RULE 29.6 STATEMENT	i
TABLE OF AUTHORITIES	iv
REPLY BRIEF	1
CONCLUSION	10

TABLE OF AUTHORITIES

CASES Page

ACM P'ship v. *Commissioner*, 157 F.3d 231 (3d Cir. 1998) 2
ASA Investerings P'ship v. *Commissioner*, 201 F.3d 505 (D.C. Cir. 2000) 2, 7 8
American Elec. Power Co. v. *United States*, 326 F.3d 737 (6th Cir. 2003) 5
American Home Prods. Corp. v. *Barr Labs., Inc.*, 834 F.2d 368 (3d Cir. 1987) 2
Black & Decker Corp. v. *United States*, 436 F.3d 431 (4th Cir. 2006) 7
Bose Corp. v. *Consumers Union of U.S., Inc.*, 466 U.S. 485 (1984) 3
In Re CM Holdings, Inc., 301 F.3d 96 (3d Cir. 2002) 8
Casebeer v. *Commissioner*, 909 F.2d 1360 (9th Cir. 1990) 8
Compaq Computer Corp. v. *Commissioner*, 277 F.3d 778 (5th Cir. 2001) 8
Cottage Sav. Ass'n v. *Commissioner*, 499 U.S. 554 (1991) 4
Frank Lyon Co. v. *United States*, 435 U.S. 561 (1978) 5
Friedman v. *Commissioner*, 869 F.2d 785 (4th Cir. 1989) 7
Horn v. *Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992) 7
Hunt v. *Commissioner*, 938 F.2d 466 (4th Cir. 1991) 7
IES Indus., Inc. v. *United States*, 253 F.3d 350 (8th Cir. 2001) 8
Knetsch v. *United States*, 364 U.S. 361 (1960) 5, 6
League of United Latin Am. Citizens v. *Perry*, 126 S. Ct. 2594 (2006) 3

TABLE OF AUTHORITIES – continued

Page

Moline Props. v. *Commissioner*, 319 U.S. 436 (1943) 8

Pleasant Summit Land Corp. v. *Commissioner*, 863 F.2d 263 (3d Cir. 1988) 2

Pullman-Standard v. *Swint*, 456 U.S. 273 (1982) 2, 3

Rexnord, Inc. v. *United States*, 940 F.2d 1094 (7th Cir. 1991) 5

Rice's Toyota World, Inc. v. *Commissioner*, 752 F.2d 89 (4th Cir. 1985) 7

Shriver v. *Commissioner*, 899 F.2d 724 (8th Cir. 1990) 8

Thor Power Tool Co. v. *Commissioner*, 439 U.S. 522 (1979) 5

United States v. *Nobles*, 422 U.S. 225 (1975) 9

United States v. *Wells*, 519 U.S. 482 (1997) 2

Yosha v. *Commissioner*, 861 F.2d 494 (7th Cir. 1988) 2

RULE

Fed. R. Civ. P. 52(a) 3

SCHOLARLY AUTHORITY

S. Stratton, *Korb Praises, Practitioners Question Enforcement Shift*, 113 Tax Notes 394 (Oct. 30, 2006) 9

OTHER AUTHORITIES

Korb Acknowledges U.S. Supreme Court May Need To Clarify Economic Substance Doctrine, Daily Tax Rep. (BNA) (Oct. 27, 2006) 9

TABLE OF AUTHORITIES – continued

Page

A. Bennett, *Tax Shelters: Government Still Confident On Shelters Even As Taxpayers Fight Appeals Losses*, Daily Tax Report (BNA) (Oct. 23, 2006) 9

J. Carreyrou & J. Drucker, *Merck Tax Disputes Could Cost It Up To $5.58 Billion*, Wall St. J., Nov. 8, 2006 10

Donald L. Korb, *Korb Gives Speech on Economic Substance Doctrine* (Jan. 25, 2005), available at 2005 TNT 16-22 (LEXIS) 9

K. Ritterpusch, *Government Armed With New Tools, Settlement Models In Fight Against Shelters*, Daily Tax Report (BNA) (Jan. 5, 2005) 10

REPLY BRIEF

Petitioner Coltec Industries Inc. ("Coltec") demonstrated in the petition for certiorari that there is a 5-3 split in the courts of appeals concerning the standard of review for determinations that a transaction lacks economic substance, and a 2-3-3 split over the substantive standard governing such determinations. Coltec further showed that the Federal Circuit's decision on those issues, and its definition of the relevant transaction to be tested for economic substance, are contrary to the decisions of this Court. The Government does not deny the circuit conflicts. Instead, intent upon preserving a powerful extrastatutory weapon in litigation against taxpayers, the Government offers only gossamer arguments that the standard-of-review issue was not preserved below, and that the conflicting substantive standards are of no importance in the administration of the revenue laws. The first question regarding the standard of review unequivocally was both passed on *and* presented below. On the second question, the Government's position is belied by the acknowledgement of the IRS Chief Counsel (and leading tax commenters) that the substantive law of economic substance is in disarray and that the three-way circuit conflict can only be resolved by this Court. Moreover, the IRS has trumpeted its intent to use the Federal Circuit's decision aggressively in tax litigation. The conflicting standards announced by the courts of appeals, and especially the decision below, have created extraordinary uncertainty in tax planning, and this Court should grant review to resolve the conflicts and to clarify what common-law powers federal courts possess to deny taxpayers benefits to which the terms of the Internal Revenue Code entitle them.

1. The Government acknowledges the 5-3 conflict over the standard of review, noting that "several courts of appeals have stated that a district court's determination as to whether a transaction had economic substance was reviewable only for clear error." Opp. 12. Nonetheless, the Government attempts

to cloud the issue by claiming, without citation, that "it is unclear whether the courts were deferring to the ultimate determination on economic substance, or merely to underlying factual determinations that may have been dispositive of that ultimate determination." *Id.* The Government is wrong. A number of decisions explain in depth why they reject *de novo* review even for "ultimate" economic substance determinations. Pet. 14-15 (discussing analysis in *Rexnord, Inc.* v. *United States*, 940 F.2d 1094, 1096 (7th Cir. 1991)).[1]

2. The Government grasps at straw in arguing (Opp. 12-13) that the standard-of-review issue is not preserved. This Court will review any question that was *either* passed on *or* presented below. *United States* v. *Wells*, 519 U.S. 482, 488 (1997) (waiver rules applicable to lower federal courts do not govern this Court). The Government concedes (Opp. 10) that the Federal Circuit passed on the standard of review, holding that "[t]he ultimate conclusion as to business purpose is a legal conclusion, which we review without deference." Pet.

[1] Additionally, the Third Circuit, citing a line of authority tracing back to *Pullman-Standard* v. *Swint*, 456 U.S. 273, 285-90 (1982), adopted the clear-error standard for tax cases and disclaimed its earlier practice of applying *de novo* review to "ultimate facts," *see Pleasant Summit Land Corp.* v. *Commissioner*, 863 F.2d 263, 268 (3d Cir. 1988), including economic substance determinations, *see ACM P'ship* v. *Commissioner*, 157 F.3d 231, 245 & n.25 (3d Cir. 1998). The court reasoned that it was improper to "'divide findings of fact into those that deal with "ultimate" and those that deal with "subsidiary" facts.'" *American Home Prods. Corp.* v. *Barr Labs., Inc.*, 834 F.2d 368, 370 n.2 (3d Cir. 1987). Contrary to the Government's claim, Opp. 12, both the D.C. and Seventh Circuits have made it clear that even ultimate findings of economic substance that involve application of law to fact are reviewed for clear error. *ASA Investerings P'ship* v. *Commissioner*, 201 F.3d 505, 511 (D.C. Cir. 2000) ("Factual findings are reviewed for clear error, and determinations of law de novo. We have held that in tax cases mixed questions of law and fact are to be treated like questions of fact.") (citations omitted); *Yosha* v. *Commissioner*, 861 F.2d 494, 499 (7th Cir. 1988) ("The question whether a particular transaction has economic substance, like other questions concerning the application of a legal standard to transactions or events, is governed by the clearly erroneous standard.").

App. 28a. Th e question of whether or not Coltec properly "preserved" th e issue before the Federal Circuit is therefore irrelevant.

Moreover, th he Government's waiver argument is contrived. It acknowledge es that Coltec argued to the Federal Circuit that "'the Court of Federal Claims' factual determinations may be disturbed only if they were clearly erroneous.'" Opp. 13 (quoting Pet. C .A. Br. 33 n.18) (alterations omitted). But the Government c ontends that by referring to "factual" determinations, Coltec "argued, at most, that the trial court's *underlying* factual find lings were reviewable only for clear error – and never suggeste d that the trial court's *ultimate* determination was also subj ect to clear-error review." *Id.* The Government's reasoni ing is baseless. Coltec never drew any distinction between ultimate and subsidiary facts or suggested that clear-error revi iew should be limited to the latter. As a general rule, all findin gs of fact after a bench trial are subject to clear-error review, F ed. R. Civ. P. 52(a) ("Findings of fact ... shall not be set aside unless clearly erroneous"), including findings of ultimate facts. *Bose Corp.* v. *Consumers Union of U.S., Inc.*, 466 U.S. 485, 501 (1984) ("Rule 52(a) applies to findings of fact, including those described as 'ultimate facts' because they may determine the outcome of litigation ...."); *Pullman-Standard* v. *Swint*, 456 U.S. 273, 287 (1982) (clear error review not limited to subsidiary facts); *League of United Latin Am. Citizens* v. *Perry*, 126 S. Ct. 2594, 2614 (2006) ("'ultimate finding'" of vote dilution reviewed for clear error). Coltec's consistent position throughout this case is that all factual findings of the Court of Federal Claims ("CFC") after bench trial – including the ultimate facts of business purpose and economic substance – are reviewable only for clear error.

Indeed, the Government inexplicably fails to disclose that Coltec repeatedly argued that very point in its Federal Circuit brief. The CFC found the economic substance doctrine satisfied by incorporating by reference its findings under the anti-

abuse test of section 357(b) of the Internal Revenue Code: "the court already has considered and held that Coltec satisfied the tax avoidance and business purpose tests in Section 357(b), therefore, *ipso facto*, the 'economic substance' doctrine is satisfied, since that doctrine requires proof of at least one of these tests." Pet. App. 115a. In its brief to the Federal Circuit, in addition to the statement of the clear-error standard quoted above, Coltec argued that "the CFC found as a matter of fact that the section 357(b) test was satisfied in this case. That fact finding is amply supported by the record, and the government falls far short of establishing that it was clearly erroneous." Reply App. 1a. Regarding the economic substance doctrine, Coltec reiterated that "the government has not demonstrated that those findings were clearly wrong – and they were not." Reply App. 2a.[2] Coltec's Federal Circuit brief could not have been clearer that a clear-error standard should be applied to all CFC findings of business purpose and economic substance (ultimate and subsidiary), and it certainly never invited the Federal Circuit to decide these questions *de novo*. The Government's waiver argument is neither relevant nor credible.[3]

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[2] *See also, e.g.*, Reply App. 3a ("the government's second-guessing of the business judgments of the decision-makers, as found by the CFC, is no substitute for proof that the court's findings were clearly erroneous"); *id.* ("[t]he CFC determined that the record established, by a clear preponderance of the evidence, that Garrison's assumption of Garlock's contingent asbestos liabilities had a bona fide business purpose that satisfied section 357(b)," and "[t]he record fully supports the CFC's finding, and the government's bald assertions to the contrary fall well short of demonstrating clear error"); *id.* ("[f]or these reasons, whether viewed as economic substance or business purpose arguments, the government's 'economic substance' challenges to the CFC's findings are meritless"); *id.* ("the CFC's findings relating to business purpose and economic substance are unassailable").

[3] The Government does not honor even the CFC's subsidiary findings; its characterization of the facts (which restates its trial position) was rejected by the CFC. Pet. App. 35a. Coltec's asbestos-related losses were not "artificial," Opp. 2; they were real economic losses arising from the taxpayer's historic business, just like the losses allowed in *Cottage Sav-*

3. Abandoning its prior position that clear error is the proper standard,[4] the Government now defends the Federal Circuit's adoption of a *de novo* standard as consistent with *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978). This is an issue for the merits stage, but the Government ignores that *Frank Lyon* applied the *de novo* standard to the proper characterization of a transaction under the tax code, where the facts were undisputed, *id.* at 563, not to the question whether a transaction may be disregarded altogether as a sham. *Frank Lyon* held only that "the general characterization of a transaction for tax purposes" (there, whether there was a "sale" giving the purchaser the right to depreciation deductions) is a question of law subject to *de novo* review, but findings of fact are not. *Id.* at 581 n.16. Indeed, in stating that standard, *Frank Lyon* relied on a case holding that the ultimate conclusion on the economic substance of a transaction was a fact issue for the jury (whereas the taxpayer's right to claim depreciation was a question of law). *Id.* (citing *American Realty Trust* v. *United States*, 498 F.2d 1194, 1197-99 (4th Cir. 1974)). Similarly, in *Knetsch* v. *United States*, this Court distinguished the trial judge's "findings" regarding economic substance from the "conclusion of law," derived from those findings, that the payments at issue were not, in substance, "interest paid ... on indebtedness" within the meaning of the Code. 364 U.S. 361, 362, 364 (1960) (omission in original).

The Federal Circuit's *de novo* standard conflicts with this Court's precedents, Pet. 16-17, but even if *arguendo* the Gov-

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ings Association v. *Commissioner*, 499 U.S. 554, 555 (1991). Moreover, despite the Government's intimation to the contrary (Opp. 4), this Court has repeatedly stated that different treatment of a transaction in tax and financial accounting is irrelevant. *E.g.*, *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 542 (1979) (financial accounting is designed to provide "useful information to management" and other parties, whereas tax accounting concerns the "equitable collection of revenue").

[4] *E.g.*, *American Elec. Power Co.* v. *United States*, 326 F.3d 737, 741 (6th Cir. 2003); *Rexnord, Inc.* v. *United States*, 940 F.2d 1094, 1096 (7th Cir. 1991).

ernment were right that the decisions of the five clear-error circuits "cannot be reconciled with" *Frank Lyon*, Opp. 12, that is a reason to grant the petition, not to deny it.

4. Finally, led astray by its position that any "ultimate" determination is a question of law, the Government claims that the Federal Circuit's decision involved only legal issues. *Id.* at 14. That is untrue. Even under a strictly objective test, issues of whether a transaction has economic substance because it "'appreciably affect[s the taxpayer's] beneficial interest'" other than tax avoidance, *Knetsch*, 364 U.S. at 366, are quintessentially factual, in this and any other case. Here, the CFC made findings on (inter alia) the business purpose of isolating asbestos liabilities, the probable effect of the adequate capitalization of the Garrison subsidiary in deterring plaintiffs from bringing or courts from granting veil-piercing claims, and the effect on the investment community and a potential acquirer of Coltec's isolation of asbestos liabilities in Garrison. Pet. 10-11, 25-27; Pet. App. 79a-91a, 116a. For example, the CFC found that "the Garrison transaction not only appeared to place one more barrier in the way of veil piercing claims, but it provided the B.F. Goodrich Corporation with a sufficient comfort level to purchase all of the Coltec Group in 1999." Pet. App. 116a. In keeping with *Frank Lyon*, this CFC finding of the ultimate fact of economic substance after a bench trial deserved deference.

5. The Government fares no better in its arguments regarding the 2-3-3 circuit conflict over the substantive standard for determining when a transaction has economic substance. The Government again acknowledges that the announced rules conflict, Opp. 15-18, but claims (in the last redoubt of every opponent of certiorari) that the conflicting rules may not "differ[] in any meaningful way" in their application. *Id.* at 18.

The Government is wrong. A circuit conflict does not depend on the happenstance of what facts were presented to a circuit in a given case: the issue is whether the circuits would apply a different rule to the *same* set of facts. Here, there is

no question that the Fourth and D.C. Circuits have announced a distinct rule (not dictum) that the test for economic substance is conjunctive: a transaction may not be disregarded unless "the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, *and* ... the transaction has no economic substance because no reasonable possibility of a profit exists." *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985) (emphasis added); *Black & Decker Corp.* v. *United States*, 436 F.3d 431, 441 (4th Cir. 2006) (noting that "subjective" purpose in the first prong must be supported by more than mere assertions of belief); *Horn* v. *Commissioner*, 968 F.2d 1229, 1238 (D.C. Cir. 1992); Pet. 19-20. The Fourth Circuit has consistently required proof on both the subjective and objective prongs. *E.g.*, *Hunt* v. *Commissioner*, 938 F.2d 466, 471-72 (4th Cir. 1991); *Friedman* v. *Commissioner*, 869 F.2d 785, 792-93 (4th Cir. 1989). Indeed, in *Black & Decker*, the Fourth Circuit, in remanding to the district court, instructed that "the trial to resolve whether Taxpayer's transaction was a sham *must determine whether both prongs* of the *Rice's Toyota* test are satisfied." 436 F.3d at 442-43 (emphasis added).[5] The Fourth Circuit's substantive standard, as applied and not just as stated, is in direct conflict with the Federal Circuit's rule, where subjective business purpose is irrelevant except as evidence probative of objective substance, Pet. App. 31a. Indeed, the Federal Circuit acknowledged the conflict. *Id.* at 24a n.14. Coltec would have prevailed under the Fourth and D.C. Circuit tests.[6]

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[5] The Government vaguely states that *Black & Decker*, like the decision below, "reversed the trial court's determination" of economic substance. Opp. 10. To clarify, the Fourth Circuit held that summary judgment was improper because there was a genuine issue of fact as to both subjective purpose and objective substance; it did not override the trial court's findings after a bench trial. *Black & Decker*, 436 F.3d at 442-43.

[6] The Government states (Opp. 19) that the D.C. Circuit did not apply the conjunctive test of *Horn* v. *Commissioner*, 968 F.2d at 1238, in *ASA Investerings Partnership* v. *Commissioner*, 201 F.3d 505 (D.C. Cir. 2000).

The Federal Circuit rule is also in conflict with those jurisdictions that apply a "unitary standard" mandating findings of *objective* economic substance and *subjective* business purpose, and a balancing of the two. Pet. 21-22. Once again these are conflicting rules; these courts do not (like the Federal, Sixth, and Eleventh Circuits) end the inquiry merely upon a finding of lack of objective economic substance, nor do they treat subjective purpose as merely probative evidence. *Id.* at 22.[7] Contrary to the Government's claim, Coltec does not "concede[]" that "it is at best questionable whether petitioner" would prevail under a unitary standard. Opp. 17. Coltec should have prevailed under the Federal Circuit's strictly objective standard, and even more easily under a unitary standard (given the strong evidence of both objective economic substance and the bona fide subjective business judgments of experienced business executives). Pet. 21-27.

ASA involved the separate (although related) inquiry of whether a partnership is a sham entity under the two-part test of *Moline Properties* v. *Commissioner*, 319 U.S. 436 (1943). The first prong of the *Moline* test looks to whether the partnership carried on any "business activity" (was it a "sham-in-fact") and the second prong to "business purpose" (which in that context is essentially the "economic substance" test). *ASA*, 201 F.3d at 512. Under that prong, the *ASA* court looked to both objective and subjective evidence, *id.* at 512-13, but the ultimate inquiry was subjective: "whether, all facts considered, the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance." *Id.* at 513. The Court ruled for the IRS because it found no such intent. *Id.* at 516. *ASA* in no way detracts from *Horn*; if anything, it underscores the necessity to find the absence of subjective business purpose.

[7] *See, e.g.*, *Shriver* v. *Commissioner*, 899 F.2d 724, 726 (8th Cir. 1990) (addressing the taxpayer's argument that the transaction had a business purpose even though the taxpayer did not dispute the objective finding of lack of economic substance). Many cases applying the unitary standard give separate consideration to the objective and subjective elements of the test. *See, e.g., In Re CM Holdings, Inc.*, 301 F.3d 96, 105-06 (3d Cir. 2002); *Casebeer* v. *Commissioner*, 909 F.2d 1360, 1363-64 (9th Cir. 1990); *IES Indus., Inc.* v. *United States*, 253 F.3d 350, 354-56 (8th Cir. 2001); *Compaq Computer Corp.* v. *Commissioner*, 277 F.3d 778, 784, 786-87 (5th Cir. 2001).

But at a minimum, Coltec would be entitled to a new determination under a unitary standard, underscoring that the rules are in conflict and this Court should grant review. This Court should look past the Government's litigation posture in this case, and heed the opinion of the IRS chief counsel that there is an entrenched conflict in the circuits that can only be resolved by this Court's intervention. *Korb Acknowledges U.S. Supreme Court May Need To Clarify Economic Substance Doctrine*, Daily Tax Rep. (BNA) (Oct. 27, 2006); Donald L. Korb, *Korb Gives Speech on Economic Substance Doctrine* (Jan. 25, 2005), *available at* 2005 TNT 16-22 (LEXIS).

6. The Government dismisses the prospective importance of this case because Congress has amended the statute governing contingent-liability transactions. Opp. 20. The issue of prospective importance is not the particular statutory provisions, but the common-law power of courts to disqualify transactions *regardless* of the Code provision at issue (which potentially affects every transaction undertaken by taxpayers). Indeed, the irrelevance of the statutory questions decided by the courts below makes this case an especially attractive one to decide solely the economic-substance question presented.[8]

The significance of the Federal Circuit's economic substance ruling cannot be overstated. The IRS has heralded the decision below as a case that will be of "wide use" in its enforcement efforts, and the Tax Division has filed 143 cases in which the doctrine will be invoked, "with trial teams already assembling for 85 of those cases." A. Bennett, *Tax Shelters: Government Still Confident On Shelters Even As Taxpayers Fight Appeals Losses*, Daily Tax Report (BNA) (Oct. 23, 2006); S. Stratton, *Korb Praises, Practitioners Question En-*

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[8] It is doubtful that the Government would raise its strained statutory arguments, which no court has accepted, Pet. App. 17a, as alternative grounds in support of the judgment. But even if it did, *see* Opp. 20 n.6, this Court always has discretion to answer only the question presented and not to reach such alternative grounds. *United States* v. *Nobles*, 422 U.S. 225, 241 n.16 (1975).

forcement Shift, 113 Tax Notes 394 (Oct. 30, 2006) (noting Korb's belief that "the principles from [the *Coltec* case, among others,] will be cited 20 years from now"); *see also* J. Carreyrou & J. Drucker, *Merck Tax Disputes Could Cost It Up To $5.58 Billion*, Wall St. J., Nov. 8, 2006, at A3. The number of filed cases is a small fraction of the audits that the IRS conducts (and the settlements it extracts) under the auspices of the economic substance doctrine across a broad array of transactions. See K. Ritterpusch, *Government Armed With New Tools, Settlement Models In Fight Against Shelters*, Daily Tax Report (BNA) (Jan. 5, 2005). Moreover, as *amici curiae* point out, the law protects good-faith subjective business judgments to eliminate undue litigation risks that chill legitimate activity; those risks are heightened by the strictly objective test (and *de novo* standard of review) established below. Br. of National Association of Manufacturers and U.S. Chamber of Commerce 3-9.[9] Finally, the Government does not dispute that the Federal Circuit's holding on the relevant transaction to be tested for economic substance, where even the tax-advantaged step of a multi-step, integrated transaction must be shown to have business purpose, injects extraordinary and deleterious uncertainty into tax planning (or that this holding is at odds with precedents of this Court and other circuits). Pet. 30. Clarity of rules in this area of the tax law is vital, and this Court's immediate review is imperative.

CONCLUSION

The petition for a writ of certiorari should be granted.[10]

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[9] The CFC credited the testimony of Coltec's CEO that he would have approved the liability-shifting transaction for non-tax business reasons even if no tax benefits were available. Pet. 6; Pet. App. 45a, 80a.

[10] Because of the importance of this issue, the Court may wish to consider this petition for the April, 2007 sitting.

Respectfully submitted,

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January 23, 2007

APPENDIX

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

No. 05-5111

[filed Sept. 6, 2005]

COLTEC INDUSTRIES, INC.

Plaintiff-Appellee,

v.

UNITED STATES,

Defendant-Appellant.

BRIEF FOR PLAINTIFF-APPELLEE COLTEC INDUSTRIES, INC.

* * * *

[22] The CFC properly rejected the government's effort to avoid this result by invoking section 357(b). By its terms, that section is relevant to gain recognition, not basis determination. Indeed, in the audit in this case, the IRS's own corporate tax experts concluded that section 357(b) could not be used to reduce Garlock's basis in its Garrison stock. Lastly, the CFC found as a matter of fact that the section 357(b) test was satisfied in this case. That fact finding is amply supported by the record, and the government falls far short of establishing that it was clearly erroneous. The CFC also correctly held that the "deductible-when-paid" exclusion was applicable. The government's argument that the statute contains an unstated qualification is contrary to the plain words of the Code and has no support.

Similarly fallacious is the government's alternative argument that an assumption of contingent liabilities is "property" under section 358(a). The government's theory would render section 358(h) superfluous.

The government's economic substance argument is equally ill-founded. That doctrine concerns transactions that were done solely to generate a tax benefit and that have no economic reality whatsoever. It has no application here. Objectively, the Garrison transaction had incontrovertible economic substance, involving among other things the transfer of substantial assets; the assumption of [23] real liabilities; the creation of a company with employees, substantial activities, and outside shareholders; and the investment of half a million dollars by those shareholders. All those changes were permanent and remain in place today. Subjectively, the CFC found that a number of bona fide business purposes motivated the participants and that tax benefits were not the main reason for the transaction. Again, the government has not demonstrated that those findings were clearly wrong – and they were not.

* * * *

[33] The government also asserts that Coltec's concern about veil-piercing "has no connection to Garrison's assumption of Garlock's liabilities." (Brief at 57) After hearing the evidence, however, the CFC found that the asbestos liabilities were assumed because management believed the assumption would help against veil-piercing claims and would make Coltec more marketable. That finding as to intent can be set aside only if clearly erroneous, which the government cannot demonstrate.[18]

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[18] The CFC's factual determinations may be disturbed only if they were clearly erroneous. *See Landmark Land Co. v. FDIC*, 256 F.3d 1365,1373 (Fed. Cir. 2001) ("We afford the trial court's findings of fact 'considerable deference,' disturbing them only if they are shown to have been 'clearly erroneous.'") (citation omitted).

* * * *

[34] ... The government's assertion that the CFC's determinations were "groundless" (Brief at 49) is wrong. In any event, the government's second-guessing of the business judgments of the decision-makers, as found by the CFC, is no substitute for proof that the court's findings were clearly erroneous. *Cf. Jacobson v. Commissioner*, 915 F.2d 832, 838-39 (2d Cir. 1990) (a court should not ignore the evidence that the decision to invest was made by informed decision-makers and make its own prediction as to whether the investment was likely to be profitable.)

* * * *

[36] The CFC determined that the record established, by a clear preponderance of the evidence, that Garrison's assumption of Garlock's contingent asbestos liabilities had a bona fide business purpose that satisfied section 357(b). (JA38) The record fully supports the CFC's finding, and the government's bald assertions to the contrary fall well short of demonstrating clear error.

* * * *

[52] For these reasons, whether viewed as economic substance or business purpose arguments, the government's "economic substance" challenges to the CFC's findings are meritless.

* * * *

[56] As demonstrated above, the CFC's findings relating to business purpose and economic substance are unassailable.

* * * *

(3)

No. 06-659

FILED

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IN THE

Supreme Court of the United States

COLTEC INDUSTRIES, INC.,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

BRIEF *AMICI CURIAE* OF THE NATIONAL ASSOCIATION OF MANUFACTURERS AND THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA IN SUPPORT OF PETITIONER

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QUESTIONS PRESENTED

1. In determining that a transaction may be disregarded for tax purposes, should a federal court of appeals review the trial court's findings that the transaction had economic substance *de novo* (as three courts of appeals have held), or for clear error (as five courts of appeals have held)?

2. Where a taxpayer made a good-faith business judgment that the transaction served its economic interests, and would have executed the transaction regardless of the tax benefits, did the court of appeals (in acknowledged conflict with the rule of other circuits) properly deny the favorable tax treatment afforded by the Internal Revenue Code to the transaction based solely on the court's "objective" conclusion that a narrow part of the transaction lacked economic benefits for the taxpayer?

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
TABLE OF AUTHORITIES	v
INTEREST OF *AMICI CURIAE*	1
SUMMARY OF THE ARGUMENT	2
I. THE DECISION BELOW THWARTS LONGSTANDING AND IMPORTANT PRINCIPLES OF JUDICIAL DEFERENCE TO BUSINESS JUDGMENT	3
A. American Company Law Reflects A Tradition Of Deference To Business Judgment	3
B. The Federal Circuit's Economic Substance Analysis Undercuts This Tradition of Deference	4
1. The decision below sows confusion over the meaning of various judicially created doctrines governing the availability of deductions and credits under the Internal Revenue Code	4
2. The lower court's standard for economic substance determinations virtually guarantees judicial second-guessing of good-faith business judgments	7
3. The Federal Circuit's division of a transaction into discrete packages takes an unrealistic view of corporate governance and calls into doubt a variety of familiar, beneficial activities previously approved by this Court and others	9

TABLE OF CONTENTS—Continued

Page

4. This case presents a particularly appropriate vehicle for resolving these important questions 13

II. THE INTERCIRCUIT DISAGREEMENT OVER THE STANDARD OF REVIEW OF "ECONOMIC SUBSTANCE" DETERMINATIONS IS AN IMPORTANT ISSUE FOR AMERICA'S BUSINESS COMMUNITY 14

CONCLUSION 16

TABLE OF AUTHORITIES

CASES Page

ACM P'ship v. Commissioner, 157 F.3d 231 (3d Cir. 1998) 6
American Elec. Power Co., Inc. v. United States, 326 F.3d 737 (6th Cir. 2003) 15
Aronson v. Lewis, 473 A.2d 805 (Del. 1984) 4
Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. 2006) 15
Brehm v. Eisner, 746 A.2d 244 (Del. 2000) 4
Cooper Indus., Inc. v. Leatherman Tool Group, Inc., 532 U.S. 424 (2001) 14
Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554 (1991) 10
Daily Income Fund, Inc v. Fox, 464 U.S. 523 (1984) 3
Dow Chem. Co. v. United States, 435 F.3d 594 (6th Cir. 2006) 15
Frank Lyon Co. v. United States, 435 U.S. 561 (1978) 9
Grutter v. Bollinger, 539 U.S. 306 (2003) 5
Illinois Tool Works, Inc. v. Independent Ink, Inc., 126 S.Ct. 1281 (2006) 4
Jacobellis v. Ohio, 378 U.S. 184 (1964) 6
Keeler v. Commissioner, 243 F.3d 1212 (10th Cir. 2001) 15
Kumho Tire Co. v. Carmichael, 536 U.S. 137 (1999) 14
Northern Indiana Pub. Serv. Co. v. Commissioner, 115 F.3d 506 (7th Cir. 1997) 11
Rogers v. United States, 281 F.3d 1108 (10th Cir. 2002) 6
State Oil Co. v. Kahn, 522 U.S. 3 (1997) 4
Sutton v. United Airlines, Inc., 527 U.S. 471 (1999) 4

TABLE OF AUTHORITIES—Continued

Page

Texas Dep't of Community Affairs v. Burdine, 450 U.S. 248 (1981) 4
TIFD III-E, Inc. v. United States, 459 F.3d 220 (2d Cir. 2006) 15
United Parcel Serv. of Am., Inc. v. Commissioner, 254 F.3d 1014 (11th Cir. 2001)..... 15
Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001) 15

STATUTORY AUTHORITIES

U.C.C. Art. 1-301 4
U.C.C. Art. 2-201(2)..... 4
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Richard W. Duesenberg, *The Business Judgment Rule and Shareholder Derivative Suits: A View from the Inside*, 60 Wash U. L. Q. 311 (1982).. 4, 5
Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 Cornell L. Rev. 261 (1986)..... 5
David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 Tax Law. 235 (1999) 6
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TABLE OF AUTHORITIES—Continued

Page

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U. S. Dep't of Commerce, Small Bus. Adm., 2006 Performance and Accountability Report .. 13

IN THE

Supreme Court of the United States

No. 06-659

COLTEC INDUSTRIES, INC.,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

BRIEF *AMICI CURIAE* OF THE NATIONAL ASSOCIATION OF MANUFACTURERS AND THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA IN SUPPORT OF PETITIONER

INTEREST OF *AMICI CURIAE* [1]

The National Association of Manufacturers ("NAM") is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the

[1] Pursuant to Supreme Court Rule 37.6, *amici* state that the brief was authored in its entirety by *amici curiae* and their counsel. No monetary contribution toward the preparation or submission of this brief was made by any person other than *amici curiae*, their members and their counsel. By letters filed with the Clerk of the Court, petitioner and respondent have consented to the filing of this brief.

competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing in America's economic future and living standards. In support of this mission, the NAM regularly files briefs *amicus curiae* in this Court and other courts.

The Chamber of Commerce of the United States of America ("Chamber") is the nation's largest federation of business companies and associations. It represents an underlying membership of more than three million business, trade and professional organizations of every size, sector and geographic region of the country. One of the Chamber's primary missions is to represent the interests of its members by filing *amicus curiae* briefs in cases involving issues of national importance to American business.

SUMMARY OF THE ARGUMENT

This Court should grant *certiorari* for two reasons, in addition to those given in Coltec's petition.

First, not only does the decision below fuel the intercircuit disagreements over the economic substance doctrine, the Federal Circuit's entire approach jeopardizes important principles of judicial deference to business judgment. Such deference reflects both a desire to facilitate efficient capital allocation and an awareness about the relative expertise of government officials and businesspeople. The decision below undermines this deep and important tradition of deference. It sows confusion over the relationship between the economic substance doctrine and other judicially created tax doctrines, virtually invites unpredictable judicial second-guessing of businesspersons' decisions and takes a wholly unrealistic view of business planning. Moreover, in light of the IRS's very public pronouncements about how it intends

to exploit the decision below, this Court's prompt intervention is necessary.

Second, the intercircuit disagreement over the standard of appellate review of "economic substance" determinations also presents an important issue for the business world. This Court routinely has granted *certiorari* to resolve disagreements over the proper standard of review and, thereby, to provide a uniform nationwide rule. In the specific context of economic substance determinations, the standard of review is especially important. The plenary review required by the court below exacerbates the lack of deference and effectively provides the Government an added and inappropriate tool in its litigation against American businesses.

ARGUMENT

I. THE DECISION BELOW THWARTS LONG-STANDING AND IMPORTANT PRINCIPLES OF JUDICIAL DEFERENCE TO BUSINESS JUDGMENT.

A. American Company Law Reflects A Tradition Of Deference To Business Judgment.

It is a "basic principle of corporate governance that the decisions of a corporation . . . should be made by the board of directors or a majority of the shareholders." *Daily Income Fund, Inc v. Fox*, 464 U.S. 523, 530 (1984). Stripped to its essence, this case concerns whether courts will defer to those judgments or second-guess them by employing a wholly unpredictable test.

Several legal doctrines exemplify a long tradition of judicial deference to business judgment. Perhaps the most familiar is the business judgment rule in corporate law, which creates "a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the

best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Accordingly, good-faith business decisions "will not be disturbed if they can be attributed to any rational business purpose." *Brehm v. Eisner*, 746 A.2d 244, 264 & n. 65 (Del. 2000).

Outside the familiar field of corporate governance, other examples abound. For example, in employment law, courts defer to the legitimate business explanations for an employer's treatment of a present or prospective employee. *See, e.g., Sutton v. United Airlines, Inc.*, 527 U.S. 471, 493-494 (1999); *Texas Dep't of Community Affairs v. Burdine*, 450 U.S. 248 (1981). In commercial law, courts do not question the certain choices made in contracts "between merchants." *See, e.g.,* U.C.C. Art. 1-301, 2-201(2), 2-207(2). An entire chapter of the Bankruptcy Code is dedicated to the proposition that companies experiencing difficult—but ultimately surmountable—financial hardship are better left in the "possession" of the debtor rather than the government. *See* 11 U.S.C. §§501 *et. seq.* In antitrust law, this Court's shift away from *per se* rules and toward a "rule of reason" analysis reflects greater judicial acceptance of business judgment about the economic rationale for a transaction. *See, e.g., Illinois Tool Works, Inc. v. Independent Ink, Inc.*, 126 S.Ct. 1281 (2006); *State Oil Co. v. Kahn*, 522 U.S. 3 (1997).

These deferential doctrines reflect two underlying principles. First, excessive governmental intrusion into business affairs chills commercial activity. *See* Richard W. Duesenberg, *The Business Judgment Rule and Shareholder Derivative Suits: A View from the Inside*, 60 Wash U. L. Q. 311, 314 (1982). Governmental scrutiny of good-faith business activity increases its costs. Furthermore, if companies perceive that such scrutiny is likely, they may choose to abandon an undertaking altogether rather than risk costly and time-consuming governmental second-guessing.

Second, business executives are better suited to determine which transactions serve a company's interests. *Cf. Grutter v. Bollinger*, 539 U.S. 306, 328 (2003) (deferring to university's determination that diversity was "essential to its educational mission"). Government officials do not face the same choices as American businesspersons. *See* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 Cornell L. Rev. 261, 273 (1986) ("A manager who makes bad business decisions is likely to have his wealth reduced or be fired; judges who make bad business decisions will continue in office with the same salary as before."); Duesenberg, 60 Wash. U. L. Q. at 314. They are not accountable to shareholders. They do not compete in a marketplace. Under immunity doctrines, rarely must they worry about liability for their actions. By contrast each of these considerations—shareholder satisfaction, market competition and liability management—is of paramount importance to the American business executive.

B. The Federal Circuit's Economic Substance Analysis Undercuts This Tradition of Deference.

In three respects, the decision below undercuts the above-described tradition of deference in American business law.

1. *The decision below sows confusion over the meaning of various judicially created doctrines governing the availability of deductions and credits under the Internal Revenue Code.*

A taxpayer who satisfies all of the technical requirements for a deduction or credit under the Internal Revenue Code does not necessarily receive that benefit. Instead, not only must the taxpayer satisfy the requirements set forth by Congress, it must also satisfy the requirements of certain judicially created doctrines such as the "substance over form"

doctrine, the sham-transaction doctrine, the business purpose requirement and the economic substance doctrine. *See* Joseph Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 12 (2000).

Even assuming their validity in a post-*Erie* world, these judicially created doctrines at least should be clear. The decision below deprives these doctrines of that essential clarity. Whereas some courts have treated doctrines such as "economic substance" and "substance over form" as separate concepts with distinct and identifiable requirements, *see, e.g., Rogers v. United States*, 281 F.3d 1108, 1113-16 (10th Cir. 2002), the court below treats them almost interchangeably, akin to some sort of general "equity" exception under the Internal Revenue Code. (Pet. App. 18a).

This latter approach has sowed confusion within the business community. *See generally* David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 Tax Law. 235, 241 (1999) ("Much confusion has been engendered, however, by the fact that the courts have sometimes failed to address lack of economic substance as a requirement separate and apart from lack of business purpose."). It deprives the business community of any clarity over the meaning of these judicially created doctrines and their requirements. Tax advisors cannot realistically offer a confident opinion about the tax treatment of a particular transaction, and, ultimately, the businesspersons advised by them lack the confidence about a transaction's consequences for the company's bottom line.

As one judge has observed, the approach exemplified by the Federal Circuit's decision amounts to little more than a "smell test" under which courts can deny favorable tax treatment to transactions that they just don't like or, worse, don't understand. *ACM P'ship v. Commissioner*, 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J., dissenting). Just as such amorphous tests chill desirable speech in the First Amendment context, *cf. Jacobellis v. Ohio*, 378 U.S. 184, 197

(1964) (Stewart, J., concurring), so too does the Federal Circuit's "I know it when I see it" test risk chilling corporate actions that may be in a company's best interest, *see infra* Part I.B.3. *See* Mark J. Silverman et al., *The Economic Substance Doctrine: Sorting Through the Federal Circuit's "We Know It When We See It" Ruling in* Coltec, Tax Executive 423 (Nov.-Dec. 2006). Rather than risk the expense and burden of litigating a transaction, a company may simply abandon it.

The typical duration of major business tax litigation makes the chilling effects of this "smell test" especially nefarious. In this case, for example, the appellate court issued its decision nearly ten years after Coltec reported the capital loss giving rise to the contested deduction. (Pet. App. 1a). The Federal Circuit's "equitable" approach thereby gives courts virtually unbounded latitude to apply the particular economic or political theories in vogue—years, or even decades, after the relevant business decisions were made.

At the threshold, therefore, this Court's intervention is necessary to decide the important and unresolved issue—further unsettled by the decision below—about the common-law power of courts to deny favorable tax treatment to transactions that satisfy the requirements set forth by Congress in the Internal Revenue Code.

2. *The lower court's standard for economic substance determinations virtually guarantees judicial second-guessing of good-faith business judgments.*

Coltec's petition ably demonstrates the intercircuit conflict over the proper test for economic substance determinations, a conflict that both commentators and the IRS's chief counsel have acknowledged. Sheryl Stratton, *Government, Tax Bar Disagree Over Impact of* Coltec, 212 Tax Notes 1 (Nov. 1, 2006); *Korb Acknowledges U.S. Supreme Court May Need to*

Clarify Economic Substance, Daily Tax Rep. (BNA) (Oct. 27, 2006). While that confusion itself supplies a reason for granting *certiorari*, the importance of the issue provides an additional reason justifying review.

The upshot of the Federal Circuit's "objective" test is that it simply ignores—indeed renders legally irrelevant—the actual reasons motivating a business executive's decision to undertake a transaction. Here is the critical portion of the opinion:

> [E]conomic substance is measured from an objective, reasonable viewpoint, not by the subjective views of the taxpayer's corporate officers. (Pet. App. 31a).

This judicial disdain for the economic judgments of American business executives undermines the above-described tradition of deference and carries all the perils of such judicial second-guessing—both the drag on economic activity and the risk of error. *See supra* Part I.A. In its opinion, the Federal Circuit quoted at length from the testimony of Coltec executives recounting the multiple reasons why they chose to create the Garrison subsidiary—to signal to the investment community that Coltec had a grip on its potential asbestos liabilities, to focus management and administration of these liabilities in a single unit, to reduce the risk of veil piercing claims against the parent company, and to make the company a potentially attractive target for a corporate merger. (Pet. App. 28a-29a, 31a). The Federal Circuit then declared that these actual subjective judgments are *wholly irrelevant* to its analysis. (Pet. App. 31a). Having cast the actual motives to one side, the only option left to a court under the Federal Circuit's test is to undertake its own fresh economic analysis of the transaction.

That is precisely what the Federal Circuit did here. At bottom, the Court's opinion rests on the belief that Coltec could have accomplished its desired business objective in a different (and less economically beneficial) way, so its

chosen course must lack economic substance. (Pet. App. 33a). Not only does this judicial second-guessing conflict with the deferential approach taken by this Court in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), *see* Pet. at 18-19, it also is fraught with risks. Apart from the lack of deference, there is a real risk that the court might get the economic analysis wrong. As a matter of tax law, several critics have demonstrated that the Federal Circuit committed just such an error in this case: it failed to explain how Coltec's very real contingent liabilities ultimately would be treated under the Internal Revenue Code. *See generally* John F. Prusiecki, Coltec: *A Case of Misdirected Analysis of Economic Substance*, 112 Tax Notes 524 (Aug. 7, 2006) (criticizing Federal Circuit's economic analysis); Silverman, Tax Executive at 432 (same). As a matter of corporate governance, the success of the Coltec executives' strategy betrays the flaws in the Federal Circuit's opinion: a major company ultimately bought Coltec after it had implemented the very plan criticized by the court below. (Pet. App. 59a).

3. *The Federal Circuit's division of a transaction into discrete packages takes an unrealistic view of corporate governance and calls into doubt a variety of familiar, beneficial activities previously approved by this Court and others.*

The other important—and erroneous—feature of the Federal Circuit's economic substance analysis is its division of the transaction into discrete steps, analyzing each separately rather than the transaction as a whole. This approach presents several problems.

For one thing, it takes a wholly unrealistic view of business planning. As any corporate executive or corporate counsel knows, transactions may proceed in multiple steps, but ultimately a unified corporate strategy connects them. Almost invariably, some step will be motivated in part—if not

wholly—by the tax consequences. *See* Prusiecki, 112 Tax Notes at 524 ("[A]ny transaction that involves any tax planning at all has one or more aspects or elements that are tax motivated and serve no nontax purposes."); Silverman, Tax Executive at 436 ("The potentially expansive reach of the economic substance test articulated in [the decision below] combined with the application of that test on a step-by-step basis raises questions with respect to virtually all tax planning . . . ."). By separating the transaction into discrete parts, the Federal Circuit's decision marks, according to several tax practitioners, a "troubling shift" that ignores the realities of business planning. Crystal Tandon & Sheryl Stratton, *Korb, Former IRS Officials Discuss Recent Shelter Cases*, 112 Tax Notes 1113 (Sept. 25, 2006).

For another thing, the logic of the decision below calls into doubt a variety of business actions motivated by a mixture of tax and non-tax considerations, including ones previously approved by this Court and others:

- *Mortgage Swaps*: In *Cottage Savings Association v. Commissioner*, this Court considered the tax treatment of mortgage swaps. 499 U.S. 554 (1991). These transactions were precipitated by the declining value of long-term, low-interest mortgages held by savings and loan institutions. Because federal banking laws at that time allowed them to swap mortgages without taking losses for regulatory accounting purposes, financial institutions swapped their mortgages in order to claim tax losses reflecting the difference between the high face value of the mortgages and their low fair market value at the time of the swaps. This Court held that the swaps qualified for the deduction and rejected the Government's argument to disallow them under the economic substance doctrine. *Id.* at 567-68. The Federal Circuit, however, would have disallowed the deduction. From an objective economic perspective, the swap worked no difference in the company's balance sheet—the original bundle of mortgages was

"substantially identical" to the swapped ones and had the same fair market value. *Id.* at 557. Thus, there was no objective economic explanation apart from the resulting tax benefits. The Federal Circuit's rule might well have deterred such swaps altogether, forcing financial institutions to carry large losses on their balance sheets without the opportunity to realize those losses.

- *Foreign Lending Subsidiaries and NIPSCO*: In the 1980's, American companies encountered difficulty raising capital domestically due to high interest rates. To ameliorate this problem, they established foreign subsidiaries which could raise money from foreign markets with lower interest rates and then lend that money to the domestic parent, with a repayment schedule tied to the foreign subsidiaries' obligations to its bond holders. The situs of those foreign subsidiaries was closely tied to the tax consequences: by locating the foreign subsidiary in a country that had a bilateral tax treaty with the United States, the domestic parent could utilize provisions relieving it of the obligation to pay withholding taxes on interest payments to the foreign subsidiary. The Seventh Circuit expressly approved this design (and the resulting favorable tax benefits), *see Northern Indiana Pub. Serv. Co. ("NIPSCO") v. Commissioner*, 115 F.3d 506 (1997), but it would fail under the Federal Circuit's rule. Under the logic of the Federal Circuit's decision, the choice to establish the foreign subsidiary would be decoupled from the choice where to locate it. While the establishment of the foreign subsidiary might have a non-tax economic explanation, the choice of location would not. It would be solely driven by the tax benefits inuring to the domestic parent from the tax treaty. Thus, if it had analyzed the facts of *NIPSCO*, the Federal Circuit would have disallowed the withholding benefit and, ultimately, increased the cost of capital to the domestic parent.

- *Choice of Corporate Form*: Businesses may take a variety of forms ranging from sole proprietorships to partnerships to corporations. While non-tax considerations may influence part of the decision, other parts of the decision may be influenced entirely by tax considerations. For example, a business may choose to adopt a corporate form, rather than a partnership, to take advantage of liability limitations. Yet tax considerations may drive entirely the choice between forms of corporation. Indeed, one of the IRS's own publications recognizes that "[a]n eligible domestic corporation *can avoid double taxation* (once to the corporation and again to the shareholders) by electing to be treated as an S-corporation." I.R.S. Pub. 583, *Starting a Business and Keeping Records* at 3, *available at* http://www.irs.gov/pub/irs-pdf/p583.pdf (emphasis added). Yet under the Federal Circuit's logic, the IRS would be giving bad advice: A court would have to bifurcate the "transaction" into two parts—(1) the choice to incorporate and (2) the choice of corporate form. While the former would have an objective economic justification, the latter would not. Consequently, a company opting for S-corporation status would not receive the favorable tax benefit.

In sum, each of these examples demonstrates how the Federal Circuit's approach—disaggregating transactions into separate steps and requiring an "objective non-tax" economic explanation for the step giving rise to the tax benefit—is simply incompatible with existing precedent and, if uncorrected, could have a damaging effect on economic activity. *See generally* Silverman, Tax Executive at 432-36 (describing several additional transactions whose tax treatment is potentially affected by Federal Circuit's analysis).

4. *This case presents a particularly appropriate vehicle for resolving these important questions.*

For two reasons, this Court needs to correct promptly the flawed economic substance analysis in the decision below.

First, the Federal Circuit is a court of nationwide jurisdiction. Unlike a regional appellate court, the Federal Circuit's decision has the potential to cast a wider precedential net in any case governed by its precedents. *See* Stratton, 212 Tax Notes 1.

Second, the IRS itself has signaled that it intends to rely heavily on that decision in its tax litigation. Just recently, the IRS's chief counsel heralded the case as one whose principles "will be cited 20 years from now" and will be of "wide use" to the IRS. Sheryl Stratton, *Korb Praises, Practitioners Question Enforcement Shift*, 113 Tax Notes 394 (Oct. 30, 2006); *Korb Acknowledges U.S. Supreme Court May Need to Clarify Economic Substance*, Daily Tax Rep. (BNA) (Oct. 27, 2006). In light of the IRS's expected use of this decision, timely correction is imperative.

Prompt correction is particularly important given the nature of business planning. In many cases, taxpayers reach settlements with the IRS before a case ever reaches trial (much less final judgment). *See* I.R.S. Manual 31.1.1.1.3 (4), *available at* http://www.irs.gov/irm/part31/ch01s01. html). Moreover, risk-averse companies may well abandon transactions altogether for fear of running afoul of the Federal Circuit's "smell" test and risking litigation with the IRS. While large companies perhaps can litigate these cases to judgment and through appeal, smaller businesses, which form the backbone of the American economy, do not have the luxury—or the legal budgets—to afford such a course. *See* U. S. Dep't of Commerce, Small Bus. Adm., 2006 Performance and Accountability Report, Executive Summary at

4 (noting that small businesses represent 99.7% of all employer firms, employ half of all private sector employees and have generated 60-80% of net new jobs annually over the last decade), *available at* http://www.sba.gov/idc/groups/public/documents/sba_homepage/03_summary.pdf.).

Thus, in addition to the reasons given in Coltec's petition, this Court should grant *certiorari* to address the important issues raised by—and to correct the deep flaws contained in —the Federal Circuit's economic substance analysis.

II. THE INTERCIRCUIT DISAGREEMENT OVER THE STANDARD OF REVIEW OF "ECONOMIC SUBSTANCE" DETERMINATIONS IS AN IMPORTANT ISSUE FOR AMERICA'S BUSINESS COMMUNITY.

Standards of review are important. They determine the level of deference that an appellate tribunal affords to trial courts. Thus, this Court has routinely granted review in cases about the proper standard of review. These include ones of special importance to the business community. *See, e.g., Cooper Indus., Inc. v. Leatherman Tool Group, Inc.*, 532 U.S. 424 (2001); *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137 (1999).

This case too presents a question about the standard of review warranting *certiorari*. *Amici* agree with Coltec that *certiorari* is warranted to resolve a mature split among the federal appellate courts on the issue. (Pet. 14-15). Additionally, the issue is important to the business community for two reasons.

First, appellate courts have been aggressive in making *de novo* determinations that transactions lack economic substance (or otherwise fail under similar doctrines) despite the fact-intensive nature of that inquiry. In several recent cases, including the decision below, the *de novo* standard has been

utilized to upset favorable rulings that taxpaying corporations obtained at the trial level. *See, e.g., TIFD III-E, Inc. v. United States*, 459 F.3d 220, 230-31 (2d Cir. 2006); *Dow Chem. Co., v. United States*, 435 F.3d 594 (6th Cir. 2006), petition for *certiorari* filed, No. 06-478 (Oct. 4, 2006). By contrast, in recent cases when the taxpayers lost in the trial court, plenary review of an "economic substance" or similar determination generally did not benefit them on appeal—the appellate court found in the Government's favor. *See, e.g., American Elec. Power Co., Inc. v. United States*, 326 F.3d 737, 741 (6th Cir. 2003); *Winn-Dixie Stores, Inc. v. Commissioner*, 254 F.3d 1313, 1315 (11th Cir. 2001); *Keeler v. Commissioner*, 243 F.3d 1212, 1217 (10th Cir. 2001). *But see United Parcel Serv. of Am., Inc. v. Commissioner*, 254 F.3d 1014, 1017 (11th Cir. 2001). The consistent tendency of appellate courts —farther removed from the evidence and testimony—to find no economic substance in business transactions suggests that the standard of review is not neutral in operation.

Second, economic substance cases are increasingly reaching the federal appellate courts. As late as the 1990's, commentators bemoaned the paucity of reported decisions on the doctrine. *See* Hariton, 52 Tax Law. 235. Since 2000, however, there have been thirteen reported appellate decisions on the subject, including four in the last year alone. *See* Pet. App. 1a-33a; *TIFD III-E, Inc.*, 459 F.3d 220; *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006); *Dow Chem. Co.*, 435 F.3d 594. Thus, the issue can only be expected to grow in importance.

CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of *certiorari*.

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